S. Hrg. 99-1087, Pt. 5

NAVY SHIPBUILDING PROBLEMS AT GENERAL DYNAMICS

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC RESOURCES, COMPETITIVENESS,
AND SECURITY ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

SECOND SESSION

PART 5

JANUARY 14, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
73-203 WASHINGTON : 1987

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

J841-29

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NAVY SHIPBUILDING PROBLEMS AT GENERAL DYNAMICS

TUESDAY, JANUARY 14, 1986

Congress of the United States,
Subcommittee on Economic Resources,
Competitiveness, and Security Economics
of the Joint Economic Committee,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room SD-106, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the subcommittee) presiding.

Present: Senator Proxmire.

Also present: Richard F. Kaufman, general counsel.

OPENING STATEMENT OF SENATOR PROXMIRE, VICE CHAIRMAN

Senator Proxmire. The subcommittee will come to order.

The hearing this morning is another in our series concerning defense contracting, with special emphasis on shipbuilding.

This hearing will move into some new areas that have not been previously examined by this committee, or by any other, so far as I know. It will deal with two sets of issues. The first concerns prices and profits on Navy shipbuilding contracts, and the way they are negotiated. The second set of issues concerns the way the Navy manages the contracts after they are signed.

We will have presented to us two reports prepared for this hearing, both quite unique and, as I said, exploring what is for us new territory.

The first report, prepared by the staff of this subcommittee, inquires into the price and profit levels established for the Trident and attack submarines awarded from 1981 to 1983 to General Dynamics and Newport News. This report takes an unusually close look at defense contract negotiations. It also is an effort to perform standard economic analysis on defense contract prices.

The author attempts to try to track price changes in defense equipment, in this case ships, in the way that economists track the prices of civilian products.

It will encompass a wide range of how Navy negotiations are carried on and how prices are influenced. Large price increases have been identified as important implications for the military buildup and for the economy.

The report will be presented by the counsel of the Joint Economic Committee, Richard F. Kaufman.

The second report will be presented by the General Accounting Office. It is the result of an investigation of allegations brought to our attention of questionable actions in the Navy's management of the Trident program.

GAO conducted its investigation here in Washington and at General Dynamics shipyard in Groton, Connecticut. The results of the investigation are revealing and disturbing. They concern misleading information and perhaps intentional misrepresentation by the contractor in order to obtain excessive progress payments from the Navy.

The GAO report will also explain how it is that the Navy agreed to pay General Dynamics more than 100 percent of its costs in progress payments which is an extraordinary departure from the usual situation.

Following the presentation of these reports, we will hear from the official Navy spokesman, Rear Adm. Don Campbell, Inspector General of the Naval Sea Systems Command.

I would like each of the witnesses to limit their presentations to 15 minutes so that the balance of the time can be reserved for questioning.

We will begin with Richard F. Kaufman, general counsel of the Joint Economic Committee. Mr. Kaufman, go right ahead.

STATEMENT OF RICHARD F. KAUFMAN, GENERAL COUNSEL, JOINT ECONOMIC COMMITTEE

Mr. KAUFMAN. Thank you very much, Mr. Chairman.

In 1984 you began asking the Navy about the matter of price and profit increases on shipbuilding contracts that were identified up to that time. It was known that prices and profits were rising on shipbuilding contracts, especially during the 1981–83 period. The question you were posing to the Navy was why.

You asked them for an explanation of this phenomenon and the Navy did provide some answers. You then asked the staff to look more closely at the facts and come up with a full explanation after an analysis and after considering such factors that could influence prices such as inflation, design changes, equipment changes and any other factors.

What I am presenting this morning is an interim report based on the information available so far. It may be updated with additional information. Some facts that you requested have been presented to the subcommittee just this morning. When this information is digested and analyzed, it will be used to supplement the present interim report.

PRICE PROBLEMS: INTERIM FINDINGS

In the meantime, the staff has had access to the pertinent contracts and many of the Navy's business documents concerning the negotiation of the contracts and our analysis of the facts and the documentation support the following findings.

(1) Contracts for the construction of 688-class attack submarines and Trident submarines awarded during the years 1981 to 1983 were substantially overpriced. In part, the overpricing was caused by higher profit margins than had been negotiated on previous sub-

marines. In part, it was caused by use of a 50–50 shareline provision concerning prospective overruns and underruns. Much of the overpricing remains unexplained.

(2) The Navy's decision in 1981 to allow an option to expire on the purchase of Trident submarines enabled General Dynamics to raise the prices substantially above the levels previously agreed to. It is estimated, based on available information, that the Trident submarine purchased in 1982 alone was overpriced by approximately $92.3 million, after adjusting for inflation. Increasing the price structure of the Trident purchased in 1982 led to similar price increases in the Tridents purchased in 1983.

(3) The Navy's decision in 1981 to terminate the competition for three attack submarines and award them to Newport News on a sole-source basis enabled the contractor to raise the price substantially for those submarines above its own previous bid on a similar ship, when adjusted for inflation.

(4) The decision by George A. Sawyer, then Assistant Secretary of the Navy, to introduce the 50–50 shareline as a new contract provision after an informal agreement had been reached with Newport News and at the end of the negotiations for those ships reopened the negotiations for the three attack submarines and enabled the contractor, in this case Newport News, to raise the price and profits substantially above his previous offer.

(5) Increasing the price structure of the three attack submarines in 1981 led to similar price increases in attack submarines awarded to General Dynamics and Newport News in 1982.

(6) The Navy purchased two attack submarines from General Dynamics in 1979 in a contract which the Navy then concluded was a buy-in. The modification of that contract with the Vertical Launch System in 1981 may bail out the contractor from the effects of the buy-in.

(7) Navy studies show that General Dynamics' profits were 10.4 percent as a return on sales, and 44.4 percent as a return on assets in 1984, both of those representing very sharp increases over the past previous several years.

I have displayed two tables on my left, Senator. These tables are derived from data provided from the Navy so they are official Navy facts about the cost and the profit rates on the Trident and attack submarines.

The first table, the one on my extreme left, concerns the Trident submarine. There's a red line going across that table which separates the ships purchased before 1982 from the ships purchased in 1982. What one sees from that table is that after the purchase of the third ship on that list in January 1981, there was a very sharp jump in the price. It went, according to that table, from $473 million for that Trident to $644.8 million for the next Trident. Since the purchase was only about 1 year apart, that is an extremely steep increase for one ship.

The second table, the one closest to you, deals with the attack submarines known as the 688 class. There the red line is drawn under the second ship in the list. The second ship was purchased in April 1979 and the price listed in that table is $152.3 million. The very next ship purchased in August 1981 is priced at $265.5 million.

Now those figures somewhat exaggerate the contract prices because they include the inflation that occurred from the time of the contract up to the time that the tables were prepared. In order to do our analysis we compared the prices on the contracts at the time of the awards. We could therefore discount the future inflation and do an analysis based just on the contract prices.

When we did that for the Trident, we found that in the first place the contract for the third Trident on the list, Trident No. 733, contained an option price for purchase of the next Trident. The next Trident was called the 734. The option price for that ship was $397.1 million. In 1981, the Navy cancelled the option or let that option expire. They later began negotiating to purchase the same ship.

When they finally purchased the ship, the contract price instead of $397.1 million was $535.6 million, again a very sharp increase in the space of about 1 year.

We took into account the inflation that had occurred between the making of the option price and the final contract price using Bureau of Labor Statistics indices and using the blend applied by the Navy in its shipbuilding inflation estimates. We found that the inflation factor was very substantial, approximately 11.64 percent; that it raised the price significantly, but not all the way to the final price.

The inflation factor raised it from $397 million to about $443 million. There was additionally a profit factor involved as the profits of the two ships under the option price and the contract price were a little different. The contract price profit was somewhat higher but that represents not a very great proportion of the full price. There remains unexplained, Senator, a price increase which we can term a real price increase, adjusted for inflation, of $92.3 million on that single Trident ship.

We believe that using the same approach for the next two Tridents purchased in 1983 brings about a very similar result, a real price increase of a very, very substantial nature.

We used the same approach on the attack class submarines trying to track prices from one ship to another, discounting for inflation. In that case, Senator, we began with the submarines purchased by the Navy in August 1981. Now previous to that purchase, the ships in question had been the subject of a competitive bid between General Dynamics and Newport News.

Early in 1981, the Navy canceled the competitive bid and decided to award the ships on sole source basis to Newport News. They then entered into new negotiations sole source with Newport News. We tried to compare the closest previous contract price bid that Newport News had made for an earlier ship, again discounting for inflation in the same manner I explained on the Trident ship. We come up with a real price increase after inflation and other factors we were able to identify which would account for some of the price increase. There remains a real price increase on the first of the three ships under that contract of $46.5 million. We fell that a similar price increase in real terms occurred with the other two ships and that they also were incorporated in the high price structure of the next ship sold to Newport News in 1982 and then two more attack submarines awarded to General Dynamics in 1982.

Finally, Senator, I want to describe one interesting episode in the August 1981 negotiations for the three attack submarines with Newport News because it sheds light not only on the negotiating process that was used but on the effects of introducing the 50-50 shareline on shipbuilding contracts on prices and profits.

Now the 50-50 shareline refers to the split that occurs when there's an overrun or an underrun on a program. If the costs exceed the target price under whatever formula the shareline indicates, the Government takes a share of the overrun and the contractor must absorb a share of the overrun. Similarly, with regard to underruns.

Now the normal share ranges around 75-25. That is, the Government usually agrees to absorb about 75 percent of the cost overrun with the contractor agreeing to absorb about 25 percent. So a 50-50 shareline could be very beneficial to the Navy, assuming one very important fact; namely, that the price is reasonable. If you have a reasonable price and there is then an overrun, under a 50-50 shareline the Government would not have to absorb quite as much as it does under a 75-25 percent shareline. But if the price is pegged artificially high—that is, if the contractor in anticipation of the greater risk of the 50-50 shareline hikes his price or for whatever other reason decides to raise his price, then the 50-50 shareline doesn't look so good.

In fact, that is partly what explains the price increase on these submarines. Because on August 3, 1981, Navy negotiators and the contractor had informally agreed on a price for the three ships. Shortly after the agreement on that price, George Sawyer, who was then Assistant Secretary of the Navy and who according to the Navy negotiation documents was taking a close personal interest in the negotiations, sprung as a surprise on both sides the 50-50 shareline provision. He asked that this be incorporated in the contract and in effect caused the negotiations to be reopened. Two days later, on August 5, there was a meeting in Mr. Sawyer's office attended by himself, other Navy officials, the president of Newport News and other company officials. At that meeting they agreed upon a new price. The new price was $25 million higher than the price that had been agreed upon just 2 days earlier.

In addition, there was a new profit factor also substantially higher than the one that had been agreed upon 2 days earlier.

The episode shows, first, the initial instance in which the 50-50 shareline was introduced and the fact that following that introduction of the new provision both the price and the profits were raised considerably.

The 50-50 shareline has been used on all subsequent submarines awarded to Newport News and General Dynamics and there is at least the possibility that that has something to do with the real price increases that have been identified in that report.

Mr. Chairman, that concludes my presentation and I would be happy to answer any questions.

[The prepared statement of Mr. Kaufman follows:]

PREPARED STATEMENT OF RICHARD F. KAUFMAN

OVERPRICING OF NAVY SHIPBUILDING CONTRACTS
AN INTERIM REPORT

Presented To The

SUBCOMMITTEE ON ECONOMIC RESOURCES,
COMPETITIVENESS, AND SECURITY ECONOMICS

Of The

JOINT ECONOMIC COMMITTEE

JANUARY 14, 1986

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SUMMARY

1. Contracts for the construction of 688-class attack submarines and Trident submarines awarded during the years 1981-1983 were substantially overpriced. In part, the overpricing was caused by higher profit margins than had been negotiated on previous submarines. In part, it was caused by use of a 50/50 shareline provision concerning prospective overruns and underruns. Much of the overpricing remains unexplained.

2. The Navy's decision in 1981 to allow an option to expire on the purchase of Trident submarines enabled General Dynamics to raise the prices substantially above the levels previously agreed to. It is estimated, based on available information, that the Trident submarine purchased in 1982 was overpriced by approximately $92.3 million, after adjusting for inflation. Increasing the price structure of the Trident purchased in 1982 led to similar price increases in the Tridents purchased in 1983.

3. The Navy's decision in 1981 to terminate the competition for three attack submarines and award them to Newport News on a sole-source basis enabled the contractor to raise the price substantially above its own previous bid on a similar submarine, when adjusted for inflation.

4. The decision by George A. Sawyer, then Assistant Secretary of the Navy, to introduce the 50/50 shareline as a new contract

provision after an informal agreement had been reached with Newport News reopened negotiations for the three attack submarines and enabled the contractor to raise the price and profits substantially above the previous offer.

5. Increasing the price structure of the three attack submarines in 1981 led to similar price increases in attack submarines awarded to General Dynamics and Newport News in 1982.

6. The Navy purchased two attack submarines from General Dynamics in 1979 in a contract which the Navy then concluded was a buy-in. The modification of that contract with the Vertical Launch System in 1981 may bailout the contractor from the effects of the buy-in.

7. Navy studies show that General Dynamics profits were 10.4 percent as a return on sales, and 44.4 percent as a return on assets in 1984.

1. Introduction

In 1984, Senator William Proxmire, Vice Chairman of the Subcommittee on Economic Resources, Competitiveness, and Security Economics, reopened an earlier investigation of Navy shipbuilding practices. In the course of the inquiry, it was learned that George A. Sawyer, a former Assistant Secretary of the Navy, had resigned his post in 1983 to work for General Dynamics, and that he had been involved in Navy contract awards to that company totaling approximately $6.5 billion during 1981-1983. A comparison of prices and profits negotiated in shipbuilding contracts awarded to General Dynamics before and after 1981 indicated large disparities, with much higher levels in the later period. The staff was directed to inquire further into the disparities. The staff proceeded to examine the relevant contracts and other documents and to interview appropriate Navy officials. A portion of the staff's work involves Newport News Shipbuilding and Dry Dock Company, a division of Tenneco.

In 1985, allegations by a Navy civilian employee of irregularities in the financial management of the Trident program were brought to the Subcommittee's attention. The allegations concerned events in the 1981-1983 period and raised serious questions about the propriety of actions taken by Navy and contractor officials which seemed related to the Subcommittee's ongoing inquiry. At Senator Proxmire's request, the General Accounting Office (GAO) undertook an investigation of the alleged improprieties. One result of GAO's efforts so far was the decision, with Senator Proxmire's concurrence, to turn over to the Department of Justice for further investigation certain documents and information concerning progress payments in the 688-class and Trident submarine construction programs.

This interim report discusses prices and profits on General Dynamics' Navy shipbuilding contracts based on the available information, with emphasis on the contracts awarded in the years 1979-1983 and other decisions made in that period.

2. Prices and Profits

Interest in the prices and profits of General Dynamics' recent shipbuilding contracts was sparked by the disclosure that George A. Sawyer, former Assistant Secretary of the Navy for Shipbuilding and Logistics, left the Navy in 1983 to take a position as Vice President of General Dynamics. While at the Navy during 1981-1983, Mr. Sawyer participated in the awarding of approximately $6.5 billion in contracts to General Dynamics. Included in the contracts signed during Mr. Sawyer's tenure were four attack submarines of the 688 class and three Trident submarines to be built at the Electric Boat Division shipyard of General Dynamics. In addition, during that period, four submarines of the 688 class were awarded to Newport News Shipbuilding and Dry Dock Company.

Responding to an inquiry by Senator Proxmire about Mr. Sawyer's role, Navy Secretary John Lehman wrote in a letter dated

March 27, 1984, "During his outstanding tenure as Assistant Secretary of the Navy for Shipbuilding and Logistics, Mr. Sawyer was in charge of the crackdown on our submarine building program at Electric Boat. Thanks to his tough and disciplined dealings, a decade-long mess was ended and General Dynamics was forced to drop more than $100 million in claims against the Navy." In later correspondence, the Secretary asserted that Mr. Sawyer had saved the taxpayer "billions of dollars." Secretary Lehman was asked to explain how Mr. Sawyer achieved such savings with respect to the award of contracts to General Dynamics, and particularly with respect to the award of 688 and Trident contracts. The Secretary replied: "Cost savings on FY82, 83, and 84 programs ($2.4B) were largely a result of competition and contracting policies and procedures initiated by Mr. Sawyer during his tenure as ASN (S&L). These policies include greater use of fixed price type contracts and increased competition, and promise to yield even more savings in the years to come." Efforts to obtain more details from the Navy about the savings that are said to have occurred have so far been unsuccessful.

a. The Sequence of Events and Decisions

The Secretary's reference, in his March 27, 1984, letter, to $100 million in claims concerns an attempt by General Dynamics in 1981 to obtain reimbursement for the costs of poor workmanship. The sequence of events leading up to the dispute over this claim and its resolution coincide with important contract decisions made during the period in question.

The Navy awarded a contract for two submarines of the 688 class to General Dynamics in 1979, the SSN 719 and 720, on the basis of a low bid (a bid was also submitted by Newport News, the only other shipyard qualified to build nuclear submarines). However, Navy negotiators believed that General Dynamics' bid was unrealistically low, that each ship would require approximately 1.2 million manhours more to build than estimated by the contractor, and that the bid was a buy-in. After notifying the contractor of the Navy's reservations, and indicating that the contractor would have to pay for any cost overruns if the contractor's estimates proved to be overly optimistic, the bid was reaffirmed and the contract was awarded.

Navy officials were concerned not only that the low bid might eventually result in higher costs to the Navy than had the ships been built by Newport News, but that General Dynamics would follow the same approach and underbid Newport News on the next group of three submarines, the SSN 721, 722, and 723, scheduled to be awarded in 1980. The Navy could find itself in two troublesome situations. If costs of the SSN 719 and 720 exceeded the contract price, General Dynamics might seek a bailout or file a claim for the overruns, causing a controversy similar to the one that had been settled in 1978. If General Dynamics obtained the contract for the next group of three submarines with another buy-in bid, Newport News might drop out of submarine construction, leaving the Navy with only one supplier of nuclear submarines.

A solution was proposed by Admiral C. R. Bryan, then Commander of the Naval Sea Systems Command (NAVSEA): immediately upon the award of the SSN 719 and 720 to General Dynamics, offer to negotiate with Newport News as a sole source for the next group of three submarines on the basis of the price it had bid for the SSN 719 and 720. As Newport News' bid was considered reasonable, the Navy would be assured a reasonable price for the follow-on ships and a second supplier for future contracts. Admiral Bryan's proposal was endorsed by the Chief of Naval Material and the Chief of Naval Operations. But it was rejected by W. Graham Claytor, Jr., then Secretary of the Navy.

A competition for the SSN 721, 722, and 723 was begun in 1980 and both companies submitted bids. In March 1981, the Navy revealed in congressional testimony extensive welding defects and other examples of poor workmanship in both 688-class and Trident submarine construction at General Dynamics. Navy officials also complained about lengthy construction delays and the backlog of undelivered ships. Shortly afterwards, Secretary Lehman canceled the competition for the new submarines and directed that they be given to Newport News under a sole-source negotiation.

At the end of the month, the Navy made another decision concerning shipbuilding at General Dynamics. On January 7, 1981, the Navy had signed a contract with the company for the construction of the eighth ship in the Trident class, the SSBN 733. That contract contained an option for the Navy to buy two additional Tridents, the SSBN 734 and the SSBN 735, at prices stated in the same contract. On March 31, 1981, the option was allowed to expire. No explanation for this action was given at the time. But, in a letter from Secretary Lehman to David S. Lewis, then Chairman of the Board of General Dynamics, explaining his prior decision to award the thre 688-class submarines to Newport News, he expressed displeasure with the contractor's performance on the Trident.

In June of that year, General Dynamics filed an $18.9 million claim on one of the submarines in which there were defective welds. The contractor argued that the Navy served as an insurer against cost increases from such problems and was legally liable. It indicated that there would be additional "insurance" claims totaling $100 million. The Navy publicly repudiated liability for the contractor's poor workmanship and rebuked the company for filing the claim.

The claim was formally rejected by the Navy on October 16, 1981. Within a week, Secretary Lehman and Mr. Lewis announced at a press conference that their differences over shipbuilding had been resolved. In January 1982, General Dynamics received a contract for a new Trident, the SSBN 734. Also in January, the Navy gave the company a contract modification to install a Vertical Launch System of missile tubes (called VLS) in the two buy-in submarines awarded in 1979, the SSN 719 and 720. In February, it was given a contract for a new 688-class submarine, the SSN 724.

b. Effects on Prices and Profits

A result of these actions was substantial price and profit increases on the submarine contracts mentioned as well as several others awarded in 1982 and 1983. Table 1 shows the large increases in prices and profit margins for the Trident submarines awarded in 1978-1983. Factors such as inflation and design changes account for only some of the increases. It is possible that more of the increases may be accounted for by those and other factors when complete information is provided by the Navy. But the disparities between price and profit levels before and after 1981 are too large to be completely explained in that way.

For example, at the time that the option was dropped for the SSBN 734 and 735 Trident submarines, General Dynamics had committed itself to build them at prices contained in the contract for the SSBN 733. The option price for the SSBN 734 was $397.1 million. The Navy could have had that ship built for that price plus an adjustment for inflation and any design changes. The price in the contract the Navy finally agreed to was $535.6 million.

TABLE I

PRICES AND PROFITS: TRIDENT SUBMARINES, 1978-1983
(Millions of Dollars, Escalated)

	Ship	Date of Award	Ship Yard	Competitive	(In Millions of Dollars)		Target Profit as Percent of Escalated Cost	Months Early (Late)	
					Target Cost Escalated	Target Profit		Original Contract	Current Contract
1.	SSBN731	2/27/78	GD	No	$379.5	$44.5	11.7%	29	(1)
2.	SSBN732	2/27/78	GD	No	379.5	44.5	11.7	29	(1)
3.	SSBN733	1/ 7/81	GD	No	473.0	50.2	10.6	4	(1)
4.	SSBN734	1/ 7/82	GD	No	634.8	79.5	12.5	12	0 1/
5.	SSBN735	11/29/82	GD	No	685.1	87.6	12.8	0	0
6.	SSBN736	11/21/83	GD	No	722.0	86.9	12.3	0	0

1/ Twelve months added to the original contract delivery schedule to incorporate D-5.

Source: U.S. Navy

There were no substantial design changes from the SSBN 733. There was considerable inflation. The contracts were about one year apart, and the base dates set out in the contracts for purposes of calculating inflation (termed escalation by the Navy) were 14 months apart. The Navy uses Bureau of Labor Statistics (BLS) indices for calculating escalation in shipbuilding. (A special blend of BLS indices is used for Trident material.) The BLS indices weighted for the proportion of labor and material used in construction, applied to the base dates in the escalation articles in the contracts, provides an average weighted growth in the indices of 11.64 pecent. Applying that figure to the option price that General Dynamics had agreed to raises the price to $443.3 million. The gap between the option price adjusted for inflation and the contract price given to General Dynamics is $92.3 million.

Part of that increase consists of higher profits. The option price contained a lower profit margin than was agreed to in the final contract. The difference in profit margins is significant but accounts for a relatively small part of the price increase. The rate of profit set out in the SSBN 733 contract is 14.3 percent. The SSBN 734 contract indicates a 17.9 percent profit. The Navy argues that profit margins are more accurately calculated from the contract price adjusted by the amount of escalation allowed under the contract. On this basis, profits increased from 10.6 percent under the SSBN 733 contract to 12.5 percent under the SSBN 734 contract. The Navy maintains that provisions were introduced into the SSBN 734 contract that shifted more of the risk of cost overruns to the contractor, and that the increase in risk justified the increase in profits. Assuming this is true, most of the $92.3 million price increase remains unexplained.

Similar price increases are contained in the contracts for the SSBN 735 and 736. It will be recalled that General Dynamics also agreed to an option price for the SSBN 735 when it signed the SSBN 733 contract. The option price for the SSBN 735 was $387.7 million; the final contract price was $530.5 million. Had the Navy been able to exercise the option, it could have purchased the SSBN 735 far below the price in the final contract, taking into account the fact that this contract was awarded in November 1982, and the additional adjustment that should be made for escalation. The option price also contained the lower profit margin. There was no option to purchase the SSBN 736 for a lower price than in the contract signed November 1983. Nevertheless, the price for this Trident submarine reflects the higher prices and profits paid for the two that preceded it. It can be argued that the price would have been substantially lower had the price structure not been increased by the SSBN 734 contract.

The most significant equipment change in Trident during this period was addition of the D-5, the Trident 2 missile. The D-5 was added to each of the Tridents discussed through a contract modification. The prices referred to above are those negotiated in the base contracts and are not influenced by the D-5.

The 688-class submarines awarded to Newport News as well as General Dynamics during this period were also substantially overpriced, from the perspective of what the Navy paid for earlier ships. Table II shows the large increases in prices and profits for the 688-class submarines awarded in 1979-1983. Inflation and design changes account for only some of the increases. Again, it is possible that more of the increases will be accounted for by those and other factors when complete information is provided by the Navy.

When the Navy canceled the competition for the SSN 721, 722, and 723 and directed that they be awarded to Newport News as a sole-source negotiation, Newport News had already submitted a competitive bid for the submarines with prices substantially below the amounts in the final contract. The Navy has not yet disclosed the competitive bid amounts to the Subcommittee. However, it is possible to construct a rough estimate of what the Navy would have paid for the submarines had they not been awarded in a sole-source negotiation, based on Newport News' prices for previous submarines of the same class.

TABLE II

PRICES AND PROFITS: 688 CLASS SUBMARINES, 1979-1983
(MILLIONS OF DOLLARS, ESCALATED)

	Ship	Date of Award	Ship Yard	Competitive	(In Millions of Dollars) Target Cost Escalated	Target Profit	Target Profit as Percent of Escalated Cost	Months Early (Late) Original Contract	Current Contract
1.	SSN719	4/16/79	GD	Yes 1/	$162.9	$17.4	10.7%	10	0
2.	SSN720	4/16/79	GD	Yes 1/	152.3	15.8	10.4	8	0
3.	SSN721	8/13/81	NNS	No 2/	265.5	33.6	12.7	(9)	(9)
4.	SSN722	8/13/81	NNS	No 2/	266.5	33.8	12.7	(9)	(9)
5.	SSN723	8/13/81	NNS	No 2/	276.8	35.1	12.7	(9)	(9)
6.	SSN724	2/11/82	GD	No	277.8	35.0	12.6	3	3
7.	SSN750	4/19/82	NNS	Yes	307.5	35.4	11.5	(6)	(6)
8.	SSN725	4/19/82	GD	Yes	307.1	39.3	12.6	(3)	(3)
9.	SSN751	11/30/82	GD	Yes	340.0	38.9	11.4	(8)	(8)
10.	SSN752	11/30/82	GD	Yes	312.9	36.9	11.8	(8)	(8)
11.	SSN754	11/28/83	GD	Yes	290.4	34.7	12.0	0	0
12.	SSN755	11/28/83	GD	Yes	274.2	33.3	12.1	0	0
13.	SSN753	11/29/83	NNS	Yes	301.1	34.6	11.5	0	0

1/ Buy-in

2/ Competitive proposals received from both NNS and EB. To sustain competitive industrial base, award of three ships was made to NNS upon negotiation of prices and one ship was suspended pending verification of EB's resolution of quality problems.

Source: U.S. Navy

Although Newport News' bid for the SSN 719 and 720 contract was the losing bid, it was considered reasonably priced by Navy negotiators at the time. (Again, General Dynamics' bid for that contract was somewhat lower, but was considered a buy-in by the Navy.) The method described in the discussion of Trident was used to derive an average weighted growth in the BLS indices for the difference in the base dates between the contract for the SSN 719 and 720, and the new contract. The time between the base dates in the escalation articles of the two contracts was 31 months, from February 1978 to September 1980. The weighted average increase in the BLS indices for that period was 25.5 percent. The price Newport News bid for the SSN 719 was $141.1 million. Applying the growth in the indices to that price raises it to $177.1 million. The contract price for the SSN 721 was $229.6 million. The price increase, after adjusting for inflation, was $52.5 million.

At least three other factors account for part of the increase. Newport News claimed there were costs due to the "break-in production" caused by the time that had elapsed since the previous 688-class contract was received, and the Navy agreed to pay these costs. There were also some design changes associated with the new contract, but these were not great. Adjustments for these two factors are estimated at about $6 million. There remains an unexplained price increase of approximately $46.5 million. As in the case of the Trident, the profit margin was increased. Navy data show that profits as a percent of escalated costs went up from an average of 10.5

percent in the contract for the SSN 719 and 720, to 12.7 percent in the contract for the SSN 721. This was a large increase in the profit rate, but it accounts for a relatively small portion of the price increase. Most of the $46.5 million price increase remains to be explained. Unexplained price increases of approximately equivalent amounts can be attributed to the two other ships included in the SSN 721 contract, the SSN 722 and 723.

The next 688-class submarine contract was for the SSN 724, awarded to General Dynamics in February 1982. This contract, like the previous one to Newport News, was awarded without competition for reasons that have not been satisfactorily explained. The price and profit margin of it closely resembles the Newport News contract awarded six months earlier. The contract price for the SSN 724 was $231.5 million, about $2 million higher than for the SSN 721. The profit rate as a percent of escalated costs was 12.6 percent.

Two months later, in April 1982, contracts for the SSN 725 and the SSN 750 were awarded to General Dynamics and Newport News, respectively. These were the first competitive submarine contracts since 1979. The contract prices were very close together. General Dynamics' price was $239.8 million; Newport News' price was $236.4 million. Again, these prices reflect the higher price structure established in the SSN 721 contract.

There was one difference. The prior contracts were modified for installation of the Vertical Launch System. The contracts for the SSN 725 and SSN 750 were the first to incorporate VLS in the basic contract. These and other changes cost about $13 million per ship. Offsetting the slight increase in prices for the new contracts with the cost of VLS and other changes, the unexplained portion of the price increase is about $5 million to $8 million less than for the other ships. This slight contraction of the price structure could be the result of the competition for the April 1982 contracts. But the price levels were still far above the pre-1981 levels.

VLS had also been made a part of the SSN 719 and 720 buy-in contract through a modification signed in January 1982. This was the same month that General Dynamics was given the SSBN 734 contract and shortly before it was given a sole-source contract for the SSN 724. There are several curious aspects to the VLS modification.

The Navy had previously taken pains to protect itself against cost overruns on this buy-in contract. Reportedly, there were large overruns on the two ships as manhour costs to construct the submarine greatly exceeded the estimates on which the price was based. Some Navy officials believe General Dynamics would have just broken even or lost money on the contract. The VLS modification apparently changed the picture. Any major design change creates opportunities for a contractor to claim that cost overruns, for whatever reason, were caused by delay and disruption or were otherwise related to the change. The effective date of the VLS modification was made retroactive to

October 1981, enhancing possibilities for concealing overruns that may have already occurred.

Finally, there is a question about the decision to modify the two ships with VLS at all. The design change calls for installing 12 missile tubes per submarine to accommodate Tomahawk cruise missiles with conventional or nuclear warheads. (Tomahawk is built by General Dynamics and McDonnell Douglas.) When the VLS modification was signed, there were about half a dozen 688-class ships under construction. Yet, only the SSN 719 and 720 were modified. If the system was deemed essential, one might think it should be installed in all ships under construction, if not retrofitted on those that had been delivered. The VLS installed on later ships was of a different design.

3. Possible Explanations for the Increases

The Navy explains the profit increases in the 688-class and Trident submarine contracts on the basis of stringent provisions that place more of the risk of cost overruns on the contractor. The most significant factor cited was the introduction in 1981 of a 50/50 shareline covering cost overruns and underruns. All fixed-price incentive contracts contain a target price and a ceiling price. If costs exceed the target price, they are shared by the Navy and the contractor according to a formula specified in the contract up to the ceiling price. Costs that exceed the ceiling price are borne entirely by the contractor. Prior to 1981, cost sharing was typically in the 80/20 or 75/25 range, with the Navy bearing the larger share. Under an 80/20 shareline, if costs exceed the target price by $10 million, the Navy would pay $8 million and the contractor would pay $2 million. From another perspective, if there is an underrun below the target price, the Navy retains 80 percent and the contractor 20 pecent. This can be construed as a weak incentive on the part of the contractor to control costs.

The Navy argues that the use of a 50/50 shareline balances the cost risk between the parties and provides the contractor a greater incentive to reduce costs. Henceforth, the contractor would have to share 50 percent of each cost overrun dollar. It would also get to keep 50 percent of each underrun dollar. The Navy was willing to increase profit rates on contracts containing the 50/50 shareline because of the increased risks of cost overruns and the cost discipline that would be imposed on the contractor. George Sawyer is credited with introducing the new shareline in fixed-price incentive contracts for major weapon systems.

One problem with the Navy's explanation that the new shareline justified an increase in profits is that it neglects to disclose that the policy also is responsible for some of the price increases. The first use of the new shareline in shipbuilding was in the contract with Newport News for the SSN 721, 722, and 723. Sole-source negotiations began soon after Secretary Lehman announced in March 1981 that the competition was being terminated and the contract would be given to Newport News. Unfortunately, the manner of the Secretary's announcement put Navy negotiators at a disadvantage. By making a decision to award the contract to Newport News on a sole-source basis, the contractor was given great leverage in the bargaining. An alternative would have been to announce that the competition was being ended, that negotiations would continue with Newport News, and that, if the price was within the range of the bids that had already been received, a contract would be awarded to Newport News.

To make matters worse, then Assistant Secretary Sawyer announced at the very end of the negotiations that he wanted the contract to have a 50/50 cost-sharing provision. This came as a surprise to the negotiators. The negotiations had gone from March to August. On August 3, Navy and company negotiators had informally agreed on a new counter offer from the company of $651 million, including $98 million profits for the three ships. However, according to Navy documents, Mr. Sawyer, "who had shown an active interest in the negotiations, subsequently advised NAVSEA that he desired the contract to have cost sharing on a 50 percent government/50 percent contractor basis above and below target cost."

This was followed on August 5 with a meeting in Mr. Sawyer's office between Mr. Sawyer, Admiral E. Fowler, Commander of NAVSEA, and then Captain Stuart Platt for the Navy; and E. Campbell, President of Newport News, W. Phillips, Vice President, D. Moore, Counsel, and F. Silva, Chief Cost Estimator for the company. In effect, negotiations were reopened. The company was informed that it was now Navy policy to use the 50/50 shareline in mature shipbuilding programs. The parties then discussed new terms for delivery schedules, profits, and price. Under the final terms agreed upon at the meeting, the price for the three ships would be $675 million, including a profit of $102.5 million, and the deliveries would be stretched out nine months for each ship. This meant that, in addition to an increased profit of $4.5 million above the amount agreed to two days earlier, the Navy had agreed to pay an increased price of $24 million, and to accept significantly later delivery. The generous terms of the contract had been made even more generous.

The stage was set for price increases of the same magnitude, in exchange for the 50/50 shareline, on the ships later awarded to General Dynamics. In a 1983 Navy study, "Financial Analysis of Major Hardware Contractors," a letter is quoted from David Lewis to shareholders of General Dynamics. The letter states, "In 1982, Electric Boat won contracts for four additional SSN 688's, bringing to six the total of ships covered by later contracts which have substantially higher prices." This statement would appear to acknowledge for both the company and those who conducted the Navy study that the price structure for submarine construction had been raised.

The 1983 Navy study makes a number of observations about low profits in General Dynamics' shipbuilding division. It observes that General Dynamics is a very labor-intensive shipyard with low levels of capital investment, and with lower labor productivity than at other yards. The study goes on to point out that the Navy then had 10 submarines of the 688 class and seven Tridents in process at the shipyard. But the study does not inquire as to how productivity might be improved. Instead, it asks whether the dollars appropriated for the ships are "high enough above costs" so that General Dynamics will begin to show an operating profit. Undoubtedly, through earlier studies or otherwise, the Navy was aware that the company had lost money on previous submarine construction, and that the shipyard was inefficient and poorly managed.

The Navy's concern over profits is reiterated in an updated Navy study completed in August 1985, "Financial Analysis of Major Defense Contractors," devoted entirely to profitability. Here it is shown that large defense contractors earn much higher profits on defense work than on commercial work, and that General Dynamics' profits were by 1984 among the most profitable in the industry. The company's shipbuilding profits experienced the largest gain of any shipyard in 1980-1984, or any division of any other contractor. Its return on sales rose from 2.6 percent to 10.4 percent. Its return on assets went from 4.5 percent o 44.4 percent.

Upon the public release of the study, Admiral Stuart Platt stated that, despite General Dynamics' high profits, its investment in equipment is lower than for most Navy contractors. The Navy has been pointedly trying to get Newport News to agree to become a second source for the Trident as a way to lower General Dynamics' profits, and is taking steps to shave the profits of other contractors. These developments are not consistent with the earlier policy to increase profits. They suggest that the margin by which profits were increased to accommodate acceptance of the 50/50 shareline may have been excessive.

INFLATION

Senator **Proxmire**. Mr. Kaufman, your figures show a 23 percent increase in the price of the Trident purchased in 1982 after inflation, a 33 percent increase in the attack submarines purchased in August 1981 after inflation. I suppose that the critics of your position would argue, first, perhaps your inflation figures are not relevant or appropriate or that they don't apply to shipbuilding and they apply to something else and they may be the Bureau of Labor Statistics general inflation application, but how do you defend yourself against the argument that your inflation figure may be inadequate and that this may be simply a reflection of a greater inflation than is reflected in government statistics?

Mr. **Kaufman**. Senator, the Navy uses a special blend of BLS indices for labor and material in order to calculate inflation in shipbuilding. We used the BLS indices provided to us by the Navy in response to our request for information as to how escalation as the Navy uses the term is calculated on ships.

DESIGN CHANGES

We are therefore confident that the blends of BLS indices we used is the same or very similar to the one the Navy has used on these very same ships because they are the BLS indices supplied to us by the Navy.

Senator **Proxmire**. Now how about design changes? Couldn't design changes account for this even over a year period?

Mr. **Kaufman**. Design changes could account for quite a lot, even more than the price increases that we have identified. However, we attempted to take into account design changes in our calculations and we have discounted any of the price increases that could be attributed to design changes.

There apparently was not a great deal of design changing or new equipment in the transition from the submarines before and after 1981 or 1982, especially in the case of the Trident submarine.

In the other instances where there were design changes, because we did have access to contract documents and modifications themselves, we were able to identify changes of design and introduction of new equipment which would affect the contract prices in question.

PROFITS

Senator **Proxmire**. Then you said that the profit factor was increased and it accounted for some of this but not much. You didn't give us any specific figure on that.

Mr. **Kaufman**. The profit margins change, Senator, after 1981. Prior to that period for the ships in question they appeared to have been in the 10 percent range, somewhat higher in some cases. After 1981, the rate of return in the contracts moved up to about 12 percent. This is basically a return on sales, not a return on investment or assets.

It's a quite substantial increase in profit margins, from a 10 percent return to a 12 percent return and it does account for some of the increase that we have identified in the prices.

Senator **Proxmire**. How much?

Mr. **Kaufman**. Well, in the case of the Trident, if you're talking about a $350 million submarine that you are then repricing with a higher profit figure, if the profit margin is increased by 1 percentage point, you would have perhaps a $3.5 million or so increase in price. If it's 2 percentage points, that would be $7 million higher.

So there is a very substantial increase in terms of the dollars involved, but in terms of the proportion of the price increase it's only a small fraction.

Senator **Proxmire**. Well, if inflation does not account for it and if design changes don't account for it and if the profit factor doesn't account for it, what can possibly account for these increases? As you said, there is a $92 million increase. What accounts for it? Is this just a giveaway by the taxpayer to the contractor?

Mr. **Kaufman**. There are several things that could account for it. One could be higher costs due, for example, to a shift in the occupational skills required to build these submarines from one year to the next imposing higher costs on the contractor because he might have to recruit individuals who are more skilled than they were formerly.

Since this was the same submarine basically from one year to the next, however, that doesn't seem to be a factor in this case.

One factor that might be involved is the accelerated depreciation factor which was introduced in 1981. That is, it came into effect in 1981. Under that accelerated depreciation, the contractor would be able to move up his depreciation or writeoff of a piece of new equipment from, say, 20 years to 10 years. If he was writing it off previously at $50 million per year over 20 years, he might be able to write it off at the rate of $100 million for 10 years. This could show up as a higher cost and could influence the price that he was charged, even though he would have the equipment for the longer period of time.

In view of the fact, however, that Navy studies show that General Dynamics has not been a large investor in new equipment, the fact that it has lagged behind other contractors and other shipbuilders in capital investment for new plant and equipment, this also does not seem to be a significant or important factor.

Finally, Senator, you mentioned giveaway. One could, through hidden profits, explain some of the price increase. There could have been padding of overhead and other expenses, padding of payroll—that is, keeping large numbers of workers on the payroll in sort of reserve that weren't really required. I just don't know whether that's the explanation. We conclude in the staff study that much of the price increase simply remains unexplained.

Senator **Proxmire**. So you think it may be hidden profit or deliberate increase in cost as a way of having a bigger base so that their profit percentage would be greater.

METHODOLOGY

Mr. Kaufman, we previously investigated spare parts overpricing such as ordinary screwdrivers and bolts and coffee pots and so forth, and we recently examined some Air Force missile programs.

In those cases the "should cost" approach was used.

How does the analysis you used for the ships differ from the "should cost" approach?

Mr. KAUFMAN. Under a should cost approach an attempt is made to estimate how much a piece of equipment should cost if there are reasonable levels of efficiency in the production and management of that equipment. Too often the Defense Department and contractors negotiate over what the actual price of the last piece of equipment was, even though it might have been based on a great amount of waste, inefficiency, and mismanagement rather than going back into the history of the production and determine if there was low efficiency and whether the price or cost could have been reduced had there been higher efficiency.

So should cost is based on efficiency and it attempts to eliminate the waste and mismanagement that has been associated with some areas of defense production.

Now shipbuilding is one of the areas in which high levels of inefficiency, waste and mismanagement have been identified. However, the approach used to estimate the prices here did not incorporate any aspects of should cost methods. It was simply an economic kind of approach in which you take the price of the last piece of equipment as a given and then you estimate the reasons for the price change on the next piece of equipment.

The price would seem, it seems to me, even more excessive if the should cost approach were employed because one would have to set aside those costs due to waste and inefficiency in ship construction.

SIGNIFICANCE OF PRICE INCREASES

Senator PROXMIRE. I have just one more question for you. What's the significance of the large real price increases that you identified, the significance?

Mr. KAUFMAN. The immediate significance concerns the relationship between the Navy and the contractors in question over the ships that were purchased under these contracts. They do shed light on the way that negotiations have been conducted and they do point to questions about the very substantial real price increases that have been identified. We have only used this method for the ships contained on the charts to my left for some of the Tridents and some of the attack submarines.

If one speculated on whether the practice of overpricing or the phenomenon of real price increases between 1 year's contract purchases and another and applied that more generally to Navy production or to all defense contracting, then I think the implications could be quite serious because it might appear that much of the military buildup that has taken place was spent for price increases rather than for real additions to our military inventory. However, this matter would require considerable further investigation.

Senator PROXMIRE. Well, to the extent that there has been a real price increase, that's exactly the result. In other words, we're spending more money but we're not getting necessarily more military power and capability. We're not getting more submarines or more efficient submarines and I would think that would be the significance of it.

Thank you very much.

Mr. **Kaufman**. Thank you.

Senator **Proxmire**. Our next witness is Mr. John Landicho, Senior Associate Director, National Security and International Affairs Division, for the U.S. General Accounting Office.

Mr. Landicho, go right ahead and I hope you would identify your colleagues and if you could confine your opening remarks to 15 minutes we would appreciate it.

We have some questions for you.

STATEMENT OF JOHN LANDICHO, SENIOR ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOHN POTOCHNEY AND JAMES JORRITSMA

Mr. **Landicho**. Thank you, Mr. Chairman. I believe I can get through my statement in 15 minutes, but I think it's important to read it in its full context, with your permission. To my left is Jim Jorritsma. He is assigned to our Boston Regional Office to handle the work at Electric Boat. To my right is John Potochney, who was the Assignment Manager—in other words, he had the supervisory responsibility for this assignment.

Mr. Chairman and members of the subcommittee, I am pleased to appear before the subcommittee to discuss the results of our review to date of specific allegations concerning mismanagement and questionable practices in the construction of Trident submarines.

ALLEGATIONS ABOUT TRIDENT PROGRAM

This work is being performed at the request of this subcommittee and, as agreed, focused on seven allegations in the five following areas: The propriety of certain payments; destruction of Navy records; task authorization and funding on a Trident submarine technical support services contract; elimination of a financial monitoring procedure; and violations of standards of conduct.

A report containing details on all of the allegations will be submitted to the subcommittee in the near future. Our testimony today will discuss our work to date on allegations covering contract payments that involve work progress and long leadtime materials, and the allegation on destruction of records.

Our review of these matters was conducted primarily at the Plans, Programs, and Financial Management Office of the Trident Submarine Ship Acquisition Program—that is PMS 396P; the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut; and the Electric Boat Division of the General Dynamics Corp.

First, it was alleged that (1) until at least 1982, the actual percentage of completion of construction of the Trident was less than the percentage claimed for progress payments, thus allowing Electric Boat to receive early progress payments, and (2) an adjustment made by the Navy in March 1982 to the system used for reporting progress constitutes proof that the early payments were occurring.

MAN-HOUR BUDGETS

Our review disclosed that, in March 1982, Electric Boat significantly increased the man-hour budgets for all contracts, with the majority of the budgeted man-hours being added to completed or in-progress work orders. The Navy's Supervisor of Shipbuilding, Conversion and Repair [Supship] at Groton notified the contractor that such budget changes would result in early progress payments and were not acceptable. In April 1982, Supship disapproved Electric Boat's system for reporting progress and began computing progress payments based on a Supship calculation of the percentage of completion. Supship continued this procedure until March 1983 when Electric Boat submitted a revised system description which Supship believed would be adequate for determining construction progress.

Our analysis of Navy documentation showed that the March 1982 budget revision was the culmination of a lengthy application of budgeting and other practices unacceptable to the Navy that had resulted in early payment of work progress prior to March 1982.

During a period beginning in mid-1980 and extending to the March 1982 budget revision, there was much correspondence indicating that Electric Boat's cost and schedule control system was not, in the Navy's judgment, fully complying with criteria in the Department of Defense (DOD) Instruction 7000.2. The criteria are intended to serve as standards for measuring the adequacy of contractor management control systems and the data and reports that are derived from that system. The documentation we reviewed showed that, in a number of instances, the Navy urged Electric Boat to cease practices that, in the Navy's opinion, had the effect of producing early payment of work progress.

Among the problems cited by the Navy was Electric Boat's practice of making retroactive changes to budget and schedule, and of overvaluing the budget allocation for work performed early in the construction cycle. The computation of labor progress was made by estimating the percent of the job completed and then multiplying by the budgeted hours for the job. Thus, an overstated labor hour budget for work to be accomplished early in the contract would result in greater reported progress.

The practice continued into March 1982, when Electric Boat significantly increased the labor hour budgets for its contracts. A total of 16 million labor hours was added to its budgets, with the majority being allocated to work authorizations which had already been completed or were in process. As a result, Electric Boat claimed 12.6 million hours during a 2-week period in which they actually expended 1.8 million hours. The budget revision would have resulted in increased progress payments had the Navy not suspended payments based on Electric Boat's system. Most of these hours were claimed against the SSN-688 II contract and the Trident I contract.

NONCOMPLIANCE WITH DOD INSTRUCTION

During our review, we also noted other instances of Electric Boat's noncompliance with DOD Instruction 7000.2 on cost and schedule control criteria. In addition to early progress payments, Navy correspondence, from late 1980 through May 1982, also stated that Electric Boat's budgeting and other practices may have resulted in suppression of cost and schedule variances on submarine costruction, and inaccurate or misleading cost reports on submarine contracts.

We did not review these matters because they were beyond the scope of this review. However, we and subcommittee staff agreed that these matters were related to the issues being reviewed by the Department of Justice Task Force currently investigating shipbuilding activities at General Dynamics' Electric Boat Division, and we discussed and provided the pertinent documents to members of the Task Force.

PROGRESS PAYMENTS

While reviewing the allegation on progress payments, we found that the Trident IV and SSN-688 VII contracts contain special retention clauses affecting payments. The prices of these contracts are $1.7 billion for three Tridents and $471 million for two SSN-688's.

The contracts contain the standard clauses that prescribe payment limitations, which vary depending on the percentage of physical completion of each submarine. The same contracts also contain a clause entitled "Special Procedures Concerning Contract Retentions." Retentions are amounts withheld by the Navy from progress payments to protect the Government's interest against various contingencies.

The retention clauses state that both parties to the contracts recognized that the retentions specified in the progress payment clauses might exceed the amount necessary to accomplish the objectives of such retentions. Consequently, the clauses specified an alternative method for computing payments which deleted the requirement to retain 2.5 percent of the contract price from each progress payment due and substituted a retention of $22.5 million and $7.5 million per Trident and SSN-688 submarine, respectively, over the lives of these contracts.

Although the stated purpose of the clauses—special retention clauses—was to change the amount of contract retention, the Navy interpreted the clauses as also deleting the payment limitations contained in the contract payment clauses which prohibit paying progress payments in excess of a specified percentage of cost incurred. Therefore, Electric Boat received the calculated payment, regardless of whether or not it exceeded actual costs incurred. We found the deletion of the payment limitations from these clauses has been costly to the Government on these two contracts.

We determined that these provisions allowed Electric Boat to receive progress payments that substantially exceeded the amounts which would have been paid under the restrictions in the standard progress payment contract clauses. The amount of additional progress payments realized on the Trident IV contract through this clause has generally been increasing over the contract period. As of August 1985, we estimated that the additional amount totaled approximately $69.6 million on the Trident IV and $1.2 million on the SSN-688 VII contracts. We also estimated that the interest cost to the Government for these additional payments, for the period February 1982 through August 1985, was approximately $9.9 million. We discussed this matter with Navy officials who agreed with our observations, but they have not yet provided us with the specific reasons for this practice.

LONG LEADTIME FUNDING

It was alleged that the amount of funding authorized for advance procurement of long leadtime materials was excessive on the Trident submarine program.

In order to conform to a submarine master construction schedule, some materials and components with long delivery leadtime [LLTM] must be purchased before the construction contract is awarded in order to have them available when needed. These LLTM are purchased through advance procurement contracts.

We found that advance procurement contracts with Electric Boat are cost, no-fee contracts whereby the contractor is reimbursed by the Navy for actual costs incurred but does not receive a profit on these costs until after the construction contract is awarded. Materials and components purchased as LLTM are included in the construction contract at a cost based on the latest information available when the contract is negotiated.

Our review disclosed that, after remaining relatively stable on the first seven Tridents, advance procurement funding on each of the following four Tridents increased from $35.5 million on the SSBN-732—the last submarine of the Trident I group contract—to $148 million on the SSBN-736. This represents an increase from 12 percent of target cost to 33 percent of target cost. Advance procurement funding for the most recently awarded SSBN-737 was $126.4 million. Then we show a table clearly indicating the trend, as well as the decline in fiscal year 1985.

Electric Boat and Navy officials stated that the need for the significant increases occurred primarily because of changes in construction sequencing which required the use of additional material earlier in the construction process.

Although construction sequencing changes have occurred and are undoubtedly responsible for some of the increase, we question whether these changes are solely responsible for the increases. Then, Mr. Chairman, we elaborate on the four reasons in my statement.

All of the above issues, Mr. Chairman, have been discussed—this is the context of the long leadtime material items—with Electric Boat and Navy officials who have requested time to prepare a response.

DESTRUCTION OF RECORDS

The final point in my statement deals with destruction of records.

It was alleged that, in November 1983, a destruction of records took place in PMS 396P of the Trident project office during a period when three investigations, one of which was a Federal Bureau of Investigation effort, were reportedly ongoing. It was further alleged that the records destruction violated the Navy's policy; potentially obstructed justice in connection with the past and ongoing investigations; and eliminated documentation that could have been used to substantiate allegations concerning the Trident program.

Our review showed that PMS 396P conducted a general records disposal effort and that most of the disposal activities occurred between September 1983 and September 1984. During this effort, many records were destroyed including files and reports. According to officials responsible for and involved in this effort, the records disposal was conducted because of a need for additional office space, and to organize PMS 396P's filing system in accord with the Navy's standard file indexing system.

Secretary of the Navy Instruction P5212.5B provides authority for specific destruction of records based on prescribed record retention standards. The Navy process classifies the retention standards for the various records according to standard subject identification codes. These codes not only identify the subject of the documents but also state how long they should be retained. Although PMS 396P compiled an inventory of documents and decided upon their disposition, we could not independently determine whether retention standards were observed on records earmarked for destruction. We were unable to do this because the subject identification codes, which would have facilitated this determination, were omitted from a designated column on the inventory listing for most of the documents.

Our review also showed that there were ongoing investigations of Trident program matters during the period in which the records disposal took place. We identified nine ongoing investigations, including three by the FBI, during the time in which most of the disposal activities occurred. We reviewed the closed case files for each of the Navy's six investigations and discussed the cases with cognizant officials. We also discussed the cases with cognizant officials. We also discussed the three FBI investigations with an FBI official. We found no evidence that PMS 396P officials were contacted about these investigations during the period in which the disposal activities occurred.

Mr. Chairman, that concludes my statement, I will be pleased to answer any questions you may have.

[The prepared statement of Mr. Landicho follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

PREPARED
STATEMENT OF

JOHN LANDICHO, SENIOR ASSOCIATE DIRECTOR

NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

SUBCOMMITTEE ON ECONOMIC RESOURCES, COMPETITIVENESS

AND SECURITY ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE

ON

ALLEGATIONS ABOUT TRIDENT SUBMARINE PROGRAM MATTERS

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss the results of our review to date of specific allegations concerning mismanagement and questionable practices in the construction of Trident submarines.

This work is being performed at the request of this Subcommittee and, as agreed, focused on seven allegations in the five following areas: the propriety of certain payments; destruction of Navy records; task authorization and funding on a Trident submarine technical support services contract; elimination of a financial monitoring procedure; and violations of standards of conduct.

A report containing details on all of the allegations will be submitted to the Subcommittee in the near future. Our testimony today will discuss our work to date on allegations covering contract payments that involve work progress and long lead time materials, and the allegation on destruction of records.

Our review of these matters was conducted primarily at the Plans, Programs, and Financial Management Office of the Trident Submarine Ship Acquisition Program (PMS 396P); the Supervisor of Shipbuilding, Conversion and Repair, Groton, Connecticut; and the Electric Boat Division of the General Dynamics Corporation.

PROGRESS OF SUBMARINE CONSTRUCTION

It was alleged that (1) until at least 1982, the actual percentage of completion of construction of the Trident was less than the percentage claimed for progress payments, thus allowing Electric Boat to receive early progress payments, and (2) an adjustment made by the Navy in March 1982 to the system used for reporting progress constitutes proof that the early payments were occurring.

Our review disclosed that, in March 1982, Electric Boat significantly increased the manhour budgets for all contracts, with the majority of the budgeted manhours being added to completed or in-process work orders. The Navy's Supervisor of Shipbuilding, Conversion and Repair (Supship) at Groton notified the contractor that such budget changes would result in early progress payments and were not acceptable. In April 1982, Supship disapproved Electric Boat's system for reporting progress and began computing progress payments based on a Supship calculation of the percentage of completion. Supship continued this procedure until March 1983 when Electric Boat submitted a revised system description which Supship believed would be adequate for determining construction progress.

Our analysis of Navy documentation showed that the March 1982 budget revision was the culmination of a lengthy application of budgeting and other practices unacceptable to the Navy that may have resulted in early payment of work progress prior to March 1982.

During a period beginning in mid 1980 and extending to the March 1982 budget revision, there was much correspondence indicating that Electric Boat's cost and schedule control system was not, in the Navy's judgement, fully complying with criteria in Department of Defense (DOD) Instruction 7000.2. The criteria are intended to serve as standards for measuring the adequacy of contractor management control systems and the data and reports that are derived from that system. The documentation we reviewed showed that, in a number of instances, the Navy urged Electric Boat to cease practices that, in the Navy's opinion, had the effect of producing early payment of work progress.

Among the problems cited by the Navy was Electric Boat's practice of making retroactive changes to budget and schedule, and of overvaluing the budget allocation for work performed early in the construction cycle. The computation of labor progress was made by estimating the percent of the job completed and then multiplying by the budgeted hours for the job. Thus, an overstated labor hour budget for work to be accomplished early in the contract would result in greater reported progress.

The practice continued into March 1982, when Electric Boat significantly increased the labor hour budgets for its contracts. A total of 16 million labor hours was added to its budgets, with the majority being allocated to work authorizations which had already been completed or were in-process. As a result, Electric Boat claimed 12.6 million hours during a 2-week period in which they actually expended 1.8 million hours. The budget revision would have resulted in increased progress payments, had the Navy not suspended payments based on Electric Boat's system. Most of these hours were claimed against the SSN 688 II contract and the Trident I contract.

During our review, we also noted other instances of Electric Boat's non-compliance with DOD Instruction 7000.2 on cost and schedule control criteria. In addition to early progress payments, Navy correspondence, from late 1980 through May 1982, also stated that Electric Boat's budgeting and other practices may have resulted in suppression of cost and schedule variances on submarine construction, and inaccurate or misleading cost reports on submarine contracts.

We did not review these matters because they were beyond the scope of this review. However, we and Subcommittee staff agreed that these matters were related to the issues being reviewed by the Department of Justice Task Force currently investigating shipbuilding activities at General Dynamics' Electric Boat Division, and we discussed and provided the pertinent documents to members of the Task Force.

CLAUSE ON CONTRACT RETENTIONS RELATED TO PROGRESS PAYMENTS

While reviewing the allegation on progress payments, we found that the Trident IV and SSN 688 VII contracts contain special retention clauses affecting payments. The prices of these contracts are $1.7 billion for 3 Tridents and $471 million for 2 SSN 688s.

The contracts contain the standard clauses that prescribe payment limitations, which vary depending on the percentage of physical completion of each submarine. The same contracts also contain a clause entitled "Special Procedures Concerning Contract Retentions." Retentions are amounts withheld by the Navy from progress payments to protect the government's interest against various contingencies.

The retention clauses state that both parties to the contracts recognized that the retentions specified in the progress payment clauses might exceed the amount necessary to accomplish the objectives of such retentions. Consequently, the clauses specified an alternative method for computing payments which deleted the requirement to retain 2.5 percent of the contract price from each progress payment due and substituted a retention of $22.5 million and $7.5 million per Trident and SSN 688 submarine, respectively, over the lives of these contracts.

Although the stated purpose of the clauses (special retention clauses) was to change the amount of contract retention, the Navy interpreted the clauses as also deleting the payment limitations contained in the contract payment clauses which prohibit paying progress payments in excess of a specified percentage of cost incurred. Therefore, Electric Boat received the calculated payment, regardless of whether or not it exceeded actual costs incurred. We found the deletion of the payment limitations from these clauses has been costly to the government on these two contracts.

We determined that these provisions allowed Electric Boat to receive progress payments that substantially exceeded the amounts which would have been paid under the restrictions in the standard progress payment contract clauses. The amount of additional progress payments realized on the Trident IV contract through this clause has generally been increasing over the contract period. As of August 1985, we estimated that the additional amount totaled approximately $69.6 million on the Trident IV and $1.2 million on the SSN 688 VII contracts. We also estimated that the interest cost to the Government for these additional payments, for the period February 1982 through August 1985, was approximately $9.9 million. We discussed this matter with Navy officials who agreed with our observations, but they have not yet provided us with the specific reasons for this practice.

ADVANCE PROCUREMENT OF LONG LEAD TIME MATERIAL

It was alleged that the amount of funding authorized for advance procurement of long lead time materials was excessive on the Trident submarine program.

In order to conform to a submarine master construction schedule, some materials and components with long delivery lead-time (LLTM) must be purchased before the construction contract is awarded in order to have them available when needed. These LLTM are purchased through advance procurement contracts.

We found that advance procurement contracts with Electric Boat are cost, no fee contracts whereby the contractor is reimbursed by the Navy for actual costs incurred but does not receive a profit on these costs until after the construction contract is awarded. Materials and components purchased as LLTM are included in the construction contract at a cost based on the latest information available when the contract is negotiated.

Our review disclosed that, after remaining relatively stable on the first 7 Tridents, advance procurement funding on each of the following 4 Tridents increased from $35.5 million on the SSBN 732 (the last submarine of the Trident I group contract) to $148 million on the SSBN 736. This represents an increase from 12 percent of target cost to 33 percent of target cost. Advance procurement funding for the most recently awarded SSBN 737 was $126.4 million. The following shows the LLTM advance procurement funding:

	SSBN 732 (FY 78)	SSBN 733 (FY 80)	SSBN 734 (FY 81)	SSBN 735 (FY 83)	SSBN 736 (FY 84)	SSBN 737 (FY 85)
LLTM Funded	$35,500,000	$70,464,818	$101,200,000	$128,980,000	$148,000,000	$126,400,000

Electric Boat and Navy officials stated that the need for the significant increases occurred primarily because of changes in construction sequencing which required the use of additional material earlier in the construction process.

Although construction sequencing changes have occurred and are undoubtedly responsible for some of the increase, we question whether these changes are solely responsible for the increases, for the following reasons:

1. The $126.4 million for the SSBN 737 included $33 million for two major components previously provided as government furnished equipment, not as long lead time material.

Exclusive of these two items the funding for the SSBN 737 was $93.4 million, a decrease of $54.6 million or 37 percent from the $148 million authorized for the previous submarine. The significant decrease raises questions about the need for the higher level of funding on the previous submarine.

2. On some Tridents, we found that Electric Boat had not spent or obligated substantial amounts of the funds authorized for advance procurement by the date the construction contract was awarded. The unobligated balances ranged from $22 million on the SSBN 732 to $66 million on the SSBN 734.

Electric Boat officials noted that a major reason for the unobligated balances was the late receipt of funding from the Navy in the advance procurement period. They stated that in some instances the funding came so close to the contract award date that there was little opportunity to purchase the material during the advance procurement period. In this regard, we noted funding of $64 million was provided as late as 2 months before contract award on the SSBN 734.

3. Procurement budgets for LLTM prepared by Electric Boat for each Trident contain an escalation reserve which has varied substantially from a low of $1.7 million on the SSBN 733 to a high of $22.5 million on the SSBN 735. We have requested explanations of these reserves from Electric Boat and the Navy.

4. In reviewing the contracts for LLTM, we noted a number of instances where construction schedule dates indicated that the materials did not need to be purchased prior to the award of the construction contract, and, therefore, should not have been

funded as LLTM. For example, a LLTM schedule dated August 1982 stated that in order for materials valued at $2.7 million to be available when needed, the purchase requisition should be initiated in June 1984. This was 8 months after the construction contract was awarded for the SSBN 736.

All of the above issues, Mr. Chairman, have been discussed with Electric Boat and Navy officials who have requested time to prepare a response.

DESTRUCTION OF RECORDS

It was alleged that, in November 1983, a destruction of records took place in PMS 396P of the Trident project office during a period when three investigations, one of which was a Federal Bureau of Investigation (FBI) effort, were reportedly ongoing. It was further alleged that the records destruction violated the Navy's policy; potentially obstructed justice in connection with the past and ongoing investigations; and eliminated documentation that could have been used to substantiate allegations concerning the Trident program.

Our review showed that PMS 396P conducted a general records disposal effort and that most of the disposal activities occurred between September 1983 and September 1984. During this effort, many records were destroyed including files and reports. According to officials responsible for and involved in the effort, the records disposal was conducted because of a need for additional office space, and to organize PMS 396P's filing system in accord with the Navy's standard file indexing system.

Secretary of the Navy Instruction P5212.5B provides authority for the periodic destruction of records based on prescribed record retention standards. The Navy process classifies the retention standards for the various records according to standard subject identification codes. These codes not only identify the subject of the documents but also state how long they should be retained. Although PMS 396P compiled an inventory of documents and decided upon their disposition, we could not independently determine whether retention standards were observed on records earmarked for destruction. We were unable to do this because the subject identification codes, which would have facilitated this determination, were omitted from a designated column on the inventory listing for most of the documents.

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Mr. Chairman, that concludes my statement, I will be pleased to answer any questions you have.

PROGRESS PAYMENTS

Senator **PROXMIRE**. Thank you, sir.

Mr. Landicho, let's talk about the progress payments first. Can you explain briefly what progress payments are and why it is important to the taxpayer that payments under a contract not be excessive?

Mr. **LANDICHO**. Progress payments are made from time to time recognizing that in shipbuilding it takes a period of time for the contractor to get reimbursed for certain work completed.

It's important to the taxpayer that the calculated amounts be correct since we are dealing with taxpayers' dollars.

Mr. **POTOCHNEY**. Senator, progress payments on the Navy shipbuilding contracts differ from progress payments made on other DOD contracts. They are based upon reported progress as the ship construction proceeds. Therefore, the contractor is paid for work presumably completed as the ship proceeds along toward the end of the contract.

An important element of progress payments in shipbuilding, as we have found in our current work, is the earned value. Earned value is an important element in the computation of progress payments at Electric Boat.

Senator **PROXMIRE**. As I understand, the way progress payments work out then, the payments are made frequently—weekly?

Mr. **POTOCHNEY**. Biweekly.

Senator **PROXMIRE**. Biweekly. So that there's no real prospect for the contractor to incur a debt obligation? In other words, he doesn't have to borrow from a bank in order to maintain his payments for labor and supplies and so forth?

Mr. **POTOCHNEY**. That's correct.

Senator **PROXMIRE**. That's paid for by the Navy as the costs are incurred. The invoices are sent to the Navy in this case, and the Navy reimburses them promptly on a biweekly basis?

Mr. **POTOCHNEY**. That is correct. It is considered as a part of the financing element of the contract.

Senator **PROXMIRE**. Now it seems to me that the essence of that is that you should only pay them for payments that they actually incur.

So what does overprogressing mean and, if it occurs, does it add to the taxpayers' cost? Does that mean that you pay them more than they actually expend? If so, how can we possibly justify that?

Mr. **LANDICHO**. What it refers to, Senator, they are getting more money too soon. In other words, it's early progress payments.

Senator **PROXMIRE**. In other words, they're getting their money before they incur the cost?

Mr. **LANDICHO**. That's correct.

Senator **PROXMIRE**. Did that take place in this case?

Mr. **LANDICHO**. Yes, it did.

Senator **PROXMIRE**. To what extent?

Mr. **LANDICHO**. What we did, sir, was to point out in my statement that when we compared the difference between the two methods that it did result in early payments to the contractors and that the Navy documentation time and time again points out the number of instances where it indicates early progress payments have been made.

Senator **Proxmire**. Well, of course, you get that kind of a situation—if you're a contractor and I make an early payment to you, that means that I lose the use of the money, that you as the contractor get it, and you can put it into Treasury securities or whatever and earn an income on it.

Mr. **Landicho**. That's correct.

Senator **Proxmire**. And then you expend it as you incur the cost. So that the shipbuilder then is making a profit out of work that he doesn't actually provide, or at least provide on time.

Now overprogressing, does that mean that the Navy actually pays more then was incurred in costs by the contractor?

Mr. **Landicho**. Navy documents show that during the period, August 1980 through March 1982, that early payments were in fact made, Senator.

Senator **Proxmire**. Early payments?

Mr. **Landicho**. That's right, early progress payments.

Senator **Proxmire**. Is that what you mean by overprogressing?

Mr. **Potochney**. Overprogressing, Senator, means the percentage of work that is completed, and reported to the Navy by progress payment invoices, is inflated.

Senator **Proxmire**. In other words, the contractor claims that he does more work than he actually performs?

Mr. **Potochney**. That is correct.

Senator **Proxmire**. That is correct?

Mr. **Potochney**. Yes, sir.

Senator **Proxmire**. Did you find in your investigations there was an overprogressing problem in the Trident program?

Mr. **Potochney**. Yes, sir. Our investigation disclosed that beginning in March 1980 the Navy approved Electric Boat's management control system as being in compliance with DOD Instruction 7000.2. The importance of this, Senator, is that this is a process in which the Department of Defense prescribes criteria. If the contractor's control system meets the criteria, then the military procuring activity is assured that the data and reports being submitted from that system are accurate, complete and can be relied on.

Senator **Proxmire**. Now did the Navy indicate to you that overprogressing had occurred prior to March 1982?

Mr. **Potochney**. No. The situation was as follows: Navy documentation indicates that the budgeting practices that the contractor was following prior to March 1982 which put its system out of compliance with the DOD criteria, and which the Navy found unacceptable, had the result, among others, of producing early payment of work progress.

This is contained in Navy documentation, and there are references to these practices a number of times in a period from mid-1980 through March 1982.

Senator **Proxmire**. Now does the Navy know how much overprogressing there was before March 1982 and over what time period and which ships were involved? Do they know those facts?

Mr. **Potochney**. There was no indication that the Navy ever determined to what extent overprogressing or payment of early work progress occurred prior to March 1982.

Senator PROXMIRE. Was there any explanation? Why hasn't the Navy gone back to find out how much overprogressing there was and recover the excess amounts involved with interest? Why didn't they do that?

Mr. POTOCHNEY. Mr. Jorritsma has some information.

Senator PROXMIRE. All right, sir. Go ahead.

Mr. JORRITSMA. During that time period the Navy was conducting what they called an ongoing dialogue with the contractor. They had recognized the problems that Mr. Potochney referred to. They conducted what's called a subsequent application review in June 1981 which identified more of the problems. There was correspondence and discussion with the contractor in an attempt to get Electric Boat to change those practices and adhere to the DOD instruction. And that basically was the course of action that they had elected to take.

Senator PROXMIRE. Is it possible that any overprogressing before 1982 was based on false statements supplied by General Dynamics to the Navy and that there was a violation of the False Statements Act?

Mr. LANDICHO. We pursued this question with Supship officials and they, the Navy, decided on seeking corrective actions on the part of Electric Boat with this dialogue and I note, Mr. Chairman, that Navy witnesses follow us and perhaps this question is a good question to be raised with them.

Senator PROXMIRE. You said that in March 1982 Electric Boat significantly increased the man-hour budgets for all contracts. By all contracts, do you mean all the attack submarines and Trident submarines being built in the shipyard?

Mr. LANDICHO. Yes, we do.

Senator PROXMIRE. You go on to say that Electric Boat claimed 12.6 million hours. I think this is one of the most shocking and striking aspects of your statement. You say that Electric Boat claimed 12.6 million hours during a 2-week period when they actually spent only 1.8 million hours. In other words, they claimed many, many times more hours than they actually spent.

Was this an attempt to extract greater progress payments from the Navy than the company was entitled to, in your judgment?

Mr. LANDICHO. Yes, it was, in my opinion.

Senator PROXMIRE. It's such an enormous discrepancy. My heavens. It's 1.8 million hours that they actually spent and they claimed 12.6 million hours.

Mr. LANDICHO. We point out two things, Senator. When this occurred back in March 1982, this was the culmination of the dialogue between Navy and Electric Boat and at this point in time they submitted such information, and we point out very clearly that had the Navy not suspended payment it would have increased progress payments. So I have to agree with your concerns.

Senator PROXMIRE. If the Navy had not suspended its payments they would have had to pay more?

Mr. LANDICHO. Yes, I believe so.

Senator PROXMIRE. What I'm pointing out is that they paid far more than was actually spent.

Mr. LANDICHO. Yes, that would be correct.

Senator **Proxmire**. That was the claim. The Navy didn't pay it, but that was the claim?

Mr. **Landicho**. Yes, back in March 1982.

Senator **Proxmire**. Do you have an estimate of how extensive the payments would have been if the Navy paid them after March 1982 on the basis of General Dynamics' misleading claim?

Mr. **Landicho**. I think we will have Mr. Jorritsma answer that and give you the details on that, sir.

Mr. **Jorritsma**. The bulk of the hours was claimed against two contracts, the Trident I and 688 II. The Trident I was cost limited at the time—payment limited—and it would not have had an effect there. On the 688 II contract, however, the Navy's recalculation of the progress percentage resulted in an average of $11.3 million decrease during the year that it was suspended.

Senator **Proxmire**. Why don't you follow up, Mr. Kaufman?

Mr. **Kaufman**. How much do you estimate would have been paid in excessive progress payments on all the ships had that claim been accepted?

Mr. **Jorritsma**. We limited our review to the two contracts because they received 11 million hours out of the 12.6 million hours that were claimed. The other 1.6 million hours were spread over a number of contracts and we didn't look at those.

So, for the two contracts reviewed, we're saying that it would have been about $11.3 million.

Mr. **Kaufman**. There would have been an $11.3 million excessive progress payment or a progress payment earlier in that amount than should have taken place?

Mr. **Jorritsma**. It would have been $11.3 million higher under EB's method, yes.

Mr. **Kaufman**. And that's just for the contracts that you looked into. There were other contracts underway in the shipyard at the time?

Mr. **Jorritsma**. Correct.

Mr. **Kaufman**. Now is it possible that similar manpower claims in excess of what actually had been spent were presented to the Navy prior to March 1982 and were accepted by the Navy?

Mr. **Jorritsma**. It is possible, yes. The documentation that we reviewed indicates that on a number of occasions that retroactive changes or budget allocation changes had taken place and the Navy was objecting to it. This was the only instance that we're aware of where they took action to suspend the system or to change the progress payment.

REFERRAL TO JUSTICE DEPARTMENT

Senator **Proxmire**. Mr. Landicho, would you explain why you concluded you should turn over to the Justice Department for possible criminal investigation documents concerning progress payments which you uncovered?

Mr. **Landicho**. First, we believed that it could be relevant to the continuing investigation or part of the investigation on the part of the subcommittee.

Second, the Navy correspondence or documents clearly pointed out other unacceptable practices that would have resulted in suppression of costs and schedule variances on submarine contracts, as well as inaccurate or misleading cost reports on the submarines.

Then, what we did, we coordinated with the staff of this subcommittee and then decided to discuss and provide the pertinent documents to members of the Department of Justice Task Force.

Senator PROXMIRE. When you advised Navy officials about your findings on progress payments, did they dispute you or did they agree with you?

Mr. LANDICHO. I attended the conference which was held on January 2 with Navy officials and what I recall, sir, is that for the most part—very large part—they agreed with GAO's observations and findings.

Senator PROXMIRE. Well, did you ask the Navy why it failed to refer this matter to the Justice Department?

Mr. LANDICHO. I don't recall that particular point during the conference.

Senator PROXMIRE. Why didn't you?

Mr. LANDICHO. I'll have to research that and get you the answer, sir.

Senator PROXMIRE. Had other GAO personnel questioned the Navy on this, to your knowledge, previously?

Mr. LANDICHO. Well, that's the reason I want to research it, sir, whether any of the staff members contacted the Navy on this. I do not have that information.

[The following information was subsequently supplied for the record:]

GAO did not question or contact the Navy abcut any referral of matters to the Department of Justice.

Senator PROXMIRE. Now you say in addition to early progress payments the Navy found Electric Boat's budgeting and other practices may have resulted in suppression of costs and schedule variances on submarine construction and inaccurate or misleading cost reports.

Now does that mean that the company may have been concealing the true status of its ships programs from the Navy, including any waste, mismanagement or fraud?

Mr. LANDICHO. The language contained herein is taken from Navy documents and we see in the Navy documents that from 1980—mid-1980 if you will—until March 1982 references to this sort of language.

Senator PROXMIRE. Now are you saying that the Navy knew this was going on in 1980 and didn't take action until 1982?

Mr. LANDICHO. That's correct. The first indication that our documents show was in August 1980 when we looked at an internal memorandum prepared by Supships and it indicated problems with the system as required by the DOD Instruction 7000.2.

INTERNAL FINANCIAL CONTRACTS

Senator PROXMIRE. Now GAO recently issued a report on the Financial Integrity Act which required that Federal agency managers to identify and correct weaknesses in internal control and accounting systems which can lead to fraud, waste and abuse in Government operations.

Is this case, in your judgment, an example of a defense contractor with weaknesses in its internal control and accounting system and, if so, what can be done about it?

Mr. LANDICHO. Yes, sir, this case clearly suggests that there is lack of internal control. I would think offhand, sir, that there has to be greater surveillance and monitoring over such matters as progress payments and the like.

Senator PROXMIRE. Mr. Landicho, would you explain whether the Navy paid shipbuilders progress payments in excess of 100 percent of their incurred costs, how this is justified, and how much the Army and Air Force pay their contractors?

Mr. LANDICHO. Are you referring at this point, Senator, to the clause on contract retention and where we quantify the additional costs?

Senator PROXMIRE. That's right.

Mr. LANDICHO. What we found here is that on two contracts, the Trident IV and the SSN-688 VII contracts, that they contained the special retention clause and——

Senator PROXMIRE. Let me just interrupt to say, Mr. Landicho, I asked you a more general question. I asked you to explain whether the Navy paid shipbuilders progress payments in excess of 100 percent of their incurred costs and how that's justified and how much the Army and Air Force—not the Navy, but the Army and Air Force pay their contractors.

Mr. LANDICHO. Well, first, I have no knowledge with me on the Army and Air Force. The only case I'm aware of, in particular, would be the case dealing with Electric Boat.

Senator PROXMIRE. Could I interrupt again and ask if your associates are familiar with that?

Mr. POTOCHNEY. Yes, sir. Senator, shipbuilding progress payments are, as I said, based on contract price and the physical progress of the ship's construction. Payments are not allowed to exceed a percentage of incurred costs. This percentage begins at 90 percent and increases as the ship passes the 25 percent, 50 percent, and 75 percent physical completion points. So, in this regard, the Navy shipbuilding progress payments are based on a more flexible system as compared with the rest of the DOD.

Senator PROXMIRE. Are they permitted legally to exceed 100 percent?

Mr. POTOCHNEY. Yes, they are.

Senator PROXMIRE. They are? How high are they permitted to go?

Mr. POTOCHNEY. The highest that we have seen in our work has been 107 percent.

Senator PROXMIRE. 107 percent?

Mr. POTOCHNEY. Yes, sir.

Senator PROXMIRE. How about the Army and Air Force?

Mr. POTOCHNEY. I have no knowledge of what the Army and Air Force pays, but it's my understanding that they are not allowed to exceed 100 percent, again, unless——

Senator PROXMIRE. In those cases they're not allowed to exceed 100 percent. In most cases, they are well below it, 80 percent or 90 percent?

Mr. POTOCHNEY. Yes, 80 or 90 percent. There are exceptions in which flexible progress payments systems can be introduced depending on the situation, but those are rare.

SPECIAL RETENTION CLAUSE

Senator PROXMIRE. Now, Mr. Landicho, you discussed the special retention clause. Does it have the effect of removing the ceiling from progress payments so that at least in theory the Navy could make progress payments to shipbuilders amounting to 110 percent, 115 percent or more of costs?

Mr. LANDICHO. When we got into this, Senator, when we took a look at the two contracts, the Trident IV and the SSN-688 VII contracts, there were two clauses. One was the standard progress payment clause that would limit the amount of payments and the other says you have to contend with the amount of retention. But when we took a look at this particular clause, it not only changed the retention but it eliminated any limitations on progress payments.

So what we did was then to calculate for these two contracts what would occur if you computed using the limitations versus what did happen in terms of the retention clauses, and found that some $69 million for the Trident IV and $1.2 million on the SSN-688 VII contracts were the additional amounts. So they got the money anyway.

Senator PROXMIRE. So the special retention clause is just a clause they slip in there and then there's no limit at all?

Mr. LANDICHO. That's right.

Senator PROXMIRE. So you could pay 150 percent or 200 percent? There's no limit?

Mr. LANDICHO. That's the way we see it, until you come to the very end of the contract. Then, there's, of course, the ceiling. But during the period involved they can be paid these additional amounts.

Senator PROXMIRE. Well, let me ask you to which contracts and how many ships was this clause added and was it done by George Sawyer who was Assistant Secretary, and did he have knowledge that it was being done? Did you find that out?

Mr. LANDICHO. Yes. We found that in terms of the contract with Electric Boat that it was applicable only to the Trident IV and the SSN-688 VII contracts. I believe they were awarded in January 1982 and February 1982, respectively.

We are aware of one other instance and it relates to a contract with Newport News that was awarded in August 1981 which contains a similar special retention clause. Although we're aware of it, we did not determine the effect on that contract as we did at Electric Boat.

Navy documents showed that the Assistant Secretary for Shipbuilding and Logistics was aware of this practice.

Senator PROXMIRE. So that in January 1982 and February 1982, those were the General Dynamics?

Mr. LANDICHO. That's correct.

Senator PROXMIRE. And the August 1981 was with Newport News?

Mr. Landicho. That's correct.

Senator Proxmire. And I referred specifically to Mr. Sawyer and you say he was aware of it?

Mr. Landicho. Yes, sir, because I believe at that point he was the Assistant Secretary of the Navy for Shipbuilding and Logistics.

Senator Proxmire. What is the highest percentage in progress payments received by General Dynamics for the Trident and what are the highest received for the attack submarines?

Mr. Landicho. I think Mr. Jorritsma could address that.

Mr. Jorritsma. On the Trident, it reached 115 percent.

Senator Proxmire. And on the attack submarines?

Mr. Jorritsma. On the attack submarines it reached 110 percent.

Senator Proxmire. 110 percent on the attack submarines.

Now, Mr. Landicho, as I understand your report, you found that on the two contracts where this special provision is found General Dynamics got $70.8 million in progress payments more than it would have without this special provision, and the interest cost to the Government as of August 1985 was about $9.9 million for those excessive progress payments. Is that correct?

Mr. Landicho. Yes, sir.

Senator Proxmire. And is it also correct that the contractor can continue getting those payments and probably still is under these contracts?

Mr. Landicho. Yes, they would.

Senator Proxmire. Now you can call that money a gift or a subsidy, interest-free loan, or whatever. Is it legal for the Navy to do that? Is there no law against paying a contractor 110 percent of costs, or in this case, 115 percent, or should there be a law?

Mr. Landicho. I'll have Mr. Potochney answer that.

Mr. Potochney. Senator, what we're speaking about here are special provisions concerning contract retentions which are allowable clauses that can be put into contracts. They govern the amount of money that will be retained on the contract.

The two clauses that we are discussing here today contain language which has an additional effect, and that effect is to remove the payment limitations on the contracts. There are legal clauses. They are clauses that are part of the negotiation process.

Senator Proxmire. So you're telling me it is legal for the Navy to do that?

Mr. Potochney. It is my understanding that the payments clauses can be structured to allow for payments that are flexible. As to whether these are legal, I do not know.

Senator Proxmire. At any rate, it's a practice, legal or illegal, which gives in effect the contractor interest-free loans for a period of maybe a year, 2 years, 3 years, so forth; is that right?

Mr. Potochney. Well, it provides additional cash-flow.

Senator Proxmire. Can you see any moral—I shouldn't say moral reason—can you see any economic reason, any justification for this kind of what seems to this Senator to be a giveaway? What's the justification for this in fact?

Mr. Potochney. Well, as we point out in our statement, Mr. Chairman, we still have to obtain from the Navy the particular reasons why they did this. In our report to you that we're going to issue, we will include that information.

LONG LEADTIME FUNDING

Senator **Proxmire**. Now in your discussion of long leadtime funding, you show that the amount of money set aside by Congress and the Navy for advance purchasing of Trident equipment prior to the award of the contracts has been excessive.

How much in unobligated balances of long leadtime funding for Trident have you identified and what is its significance, in your judgment?

Mr. **Landicho**. What we show, Senator, is that there has been a steady rise in the amount of funding for the Trident submarines. We start with the 732 boat. It was $35.5 million. By the time we get to the SSBN-736, it increased to $148 million. It then declined over the next boat, the 737, to $126.4 million.

As pointed out in my statement, there were several questions we had on the decline. The contractor and a Navy official said the increases occurred because of changes in construction sequencing, but it's questionable because of the decline between the 736 and 737. We found that Electric Boat also did not obligate or spend all its money. The unobligated balances ranged from $22 million on the 732 and to $66 million on the 734.

We saw that the procurement budgets for long leadtime items prepared by Electric Boat contained an escalation reserve. We also note that some of these items are questionable as to whether they should be included as long leadtime items. By that, we mean that they didn't have to be bought early to meet a construction schedule. They could have been purchased much later.

All of these together point out at least two things. One, how much money is really needed? If there's too much money involved, then there's too much of the funds or budget set aside for all this. And it also speaks to the management of the program.

But we haven't concluded our work in this area. In all these areas we have asked the Navy and Electric Boat officials these questions and they requested time to prepare a response. Our final report which we are going to issue will include their comments along with our evaluation.

Senator **Proxmire**. Now what happens to the money that is not spent, that is the unobligated balances? Is it returned to the Treasury or does the Navy get to use it for some other purpose?

Mr. **Landicho**. Each year, Senator, we have been asked to look at the funding and budget requests for ships programs, including the SSBN, and at times money is taken back from the Navy and returned to the Government.

Senator **Proxmire**. How about this money, the long leadtime money?

Mr. **Landicho**. Although it doesn't deal with Electric Boat, the committee print of the Senate Appropriations Committee showed that for a particular ship program some $88 million was challenged as not needed for long leadtime material. That's by way of example.

Senator **Proxmire**. You have just given us a very helpful discussion of materials that did not need to be purchased prior to the Trident contract award and should not have been funded as long leadtime items.

DESTRUCTION OF RECORDS

When that happens, isn't the effect to cause Congress to appropriate more money than is necessary and thus unnecessarily adding to the Federal deficit?

Mr. LANDICHO. Yes, sir, for this particular purpose because it doesn't qualify as long leadtime items.

Senator PROXMIRE. Now the last issue in your report concerns the destruction of Trident records by the Navy. What concerns me is that the records were destroyed during a period when numerous investigations into Trident were taking place, some by the FBI, and that during this period, September 1983 to September 1984, several congressional committees and the Justice Department were opening new investigations of the General Dynamics shipyard.

How do you explain the fact that the officials who disposed of the records were not aware of the ongoing investigations?

Mr. LANDICHO. The best way to address that question, Mr. Chairman, is our methodology. As we point out in our statement we contacted the key officials within the PMS 396P. They were the former director to that office and the current director and the person in charge of data management—in other words, that person who was responsible for inventorying and destroying the records. We could not establish through this discussion whether they—well, let me put it in the positive context—were contacted by the investigators. So then we looked to the closed case files and what we mean by that, the investigations that were open at that point but are currently closed, and took a look at the files and the records and there was no indication again within those documents that the people in 396P were contacted. But we weren't satisfied with that.

So then we talked to the investigative officials that were involved, and they would be from the NAVSEA IG, Naval Sea Systems Command Inspector General's office, and as well as discussions with an FBI official. And all of this pointed in one direction, that PMS 396 officials were not contacted by these investigations.

So we went about it in a number of ways to draw upon our conclusion.

Senator PROXMIRE. Now if the officials had been aware of the investigations, would it have been improper for them to destroy the records?

Mr. LANDICHO. Yes, it would have been.

Senator PROXMIRE. Is it correct that the persons who destroyed the records failed to list the subject identification codes in the inventory that was destroyed?

Mr. LANDICHO. Yes, sir.

Senator PROXMIRE. And you therefore do not know exactly what was destroyed?

Mr. LANDICHO. That is correct. We did substantiate there was a general records disposal effort, it was an initial effort on the part of 396P to get their files in order according to Navy policy and, as I pointed out in the statement, one of the keys to making a determination in this area is having a subject identification code for two reasons. One, it gives the subject, but also for a given document or series of documents it states the retention period. As I pointed out, the codes were omitted but the instruction says that when one has an initial effort there's a series of recommended steps that should be followed and are not mandatory.

So we concluded, therefore, that since they were recommended on the basis of initial effort, that it did not violate the Navy policy.

Senator **PROXMIRE**. Was that omission a deviation from the procedure recommended by the Navy for destruction of records?

Mr. **LANDICHO**. If the system is in place after initial effort, then the failure to put a code on, I believe, would result in a violation.

Senator **PROXMIRE**. I understand there was a Navy Inspector General investigation of this. Did the report note the omission of the identification codes or indicate that officials in the office where the destruction took place were interviewed?

Mr. **LANDICHO**. Just give me a minute here to refer to the report just to refresh my memory. What I can see from this, Mr. Chairman, the codes were not mentioned.

Mr. **KAUFMAN**. The latter part of that question was whether the Inspector General's report indicates if the officials in the office where the destruction of records took place were interviewed in the course of the Inspector General's investigation.

Mr. **LANDICHO**. The answer to that is no.

Mr. **KAUFMAN**. Does it suggest that that investigation may not have been as thorough as it should have been if in fact the report (*a*) does not mention the omission of the identification codes in the inventory of what was destroyed, and (*b*) doesn't it indicate that officials in the office where the destruction took place were not interviewed?

Mr. **LANDICHO**. Concerning the latter part, it depends on what they're investigating as to whether they should be interviewed or not. I would say that on the first question that the report, at least in my view, seems rather trite. If more of the methodology was pointed out, perhaps, it would have alleviated some questions. But as we got into this case and took a look at this, we found that the codes were important and then we addressed the issue why they were omitted. We tracked it that way.

Mr. **KAUFMAN**. You indicated earlier that if the officials in the office where the destruction took place were aware at the time that the ongoing investigations were in existence, then destruction would have been improper.

Mr. **LANDICHO**. If we did find where they were notified or contacted or were aware of the investigation and knew the investigation was ongoing, I think our review would have taken a different tack. That is, we would have certainly, with the advice of our general counsel's office, determined how to proceed, and also in concert with the Justice Department.

One of the reasons why we would do this, if we did find that, is to see that our review or whatever we do would not compromise any legal process.

Mr. **KAUFMAN**. Well, in view of that, shouldn't it have been in order for the Inspector General to have interviewed the individuals in that office to determine whether they in fact had knowledge of the investigations?

Mr. **LANDICHO**. The best way I can answer you, Mr. Kaufman, is that we knew of and looked at the IG report and we wanted to determine independently what really happened. So we were not critiquing, per se, the wherewithal or the methodology employed by the IG office.

Senator PROXMIRE. Mr. Landicho, I want to thank you very, very much. You and your colleagues have been extremely helpful. I know that you conducted this investigation over many months. I think it was a first-class job and we are most impressed and in your debt. Thank you very much, sir.

Mr. LANDICHO. Thank you.

Senator PROXMIRE. Our final witness this morning is Rear Adm. Don Campbell, the U.S. Navy Inspector General, Navy Sea Systems Command.

Admiral Campbell, we're happy to have you here. May I ask the General Accounting Office people to stand by for the rest of the hearing in case there are other questions. I don't think there will be, but there may be and we would appreciate that very much if you could.

Admiral Campbell, we have your statement and you can go right ahead. If you could finish it in about 15 minutes we would be very grateful to you. Go right ahead, sir.

STATEMENT OF REAR ADM. DON CAMPBELL, JAGC, U.S. NAVY, INSPECTOR GENERAL, NAVAL SEA SYSTEMS COMMAND, ACCOMPANIED BY REAR ADM. W.H. CANTRELL, DIRECTOR, SEA SUBMARINE, NAVSEA

Admiral CAMPBELL. Yes, Mr. Chairman. I'll make it as brief as I can.

I am Rear Adm. Don Campbell, the Inspector General, Naval Sea Systems Command (NAVSEA).

Senator PROXMIRE. Admiral, would you like to have your aide or others to sit at the table with you? If you would, that's fine, whatever you prefer.

Admiral CAMPBELL. This is Rear Admiral Cantrell, who is the SEA Submarine Director at NAVSEA.

Senator PROXMIRE. Admiral, why don't you sit up here just in case you would like to get into the dialogue. We would be happy to have you up here.

Admiral CAMPBELL. It is my pleasure to appear before this subcommittee as the Navy's representative to discuss issues involving certain nuclear submarine construction contracts awarded to General Dynamics Corp. and Newport News Shipbuilding & Dry Dock Co. It is my understanding that many of the issues to be addressed today were brought before the subcommittee by Mr. Robert Kalmin, a Navy civilian employee who served as financial manager for the Trident Submarine Program during the 1981–84 timeframe. Mr. Kalmin has subsequently requested and received a transfer to another position within NAVSEA at the identical grade level.

The subcommittee requested that Mr. Kalmin be directed to accompany me at this hearing to answer questions regarding the issues he has raised. I have talked personally to Mr. Kalmin and extended the subcommittee's request to attend. I, in fact, encouraged Mr. Kalmin to attend. I assured him that the command had no objection to his appearance and that he would be free to speak to the issues. He indicated to me that he did not desire or intend to make an appearance and he has confirmed that in writing in two statements which I believe are attached to my statement.

GAO INVESTIGATION

I have been informed by the subcommittee that the General Accounting Office [GAO] has conducted an investigation—in fact, we've heard that this morning—into allegations raised by Mr. Kalmin at the request of the subcommittee and that the results of that investigation will be presented today. NAVSEA sought a written report of the results of the GAO investigation so that we might be able to prepare a comprehensive response, but we were unsuccessful in obtaining the final report. For that reason, obviously I'm not going to be able to address a lot of the things that I heard today except in a very general sense. GAO did give us a preliminary outbrief and based on the outbrief they gave which did not have the detail that their presentation did this morning, we did not have significant disagreement with what they told us at that time.

NAVY INVESTIGATION

My office conducted an independent review of many of the same issues addressed by the GAO investigation and identified by this subcommittee. After a lengthy investigation into all the allegations raised by Mr. Kalmin, my office did conclude that those allegations had no basis in fact and that there was no evidence found of any wrongdoing on the part of the Trident program participants or any other Government employees, and I will certainly enlarge on those with your questions. Based on oral representations by GAO officials, again, we found that their results were similar to ours. The command concurs general with the report we received.

At the same time that the GAO investigation was being conducted, the Office of Special Counsel, Merit System Protection Board, also was conducting an investigation into certain allegations raised by Mr. Kalmin as to improper personnel actions. We do not have the results of that investigation, although we are led to believe that they are not inconsistent with the results of our investigation.

I am prepared to respond to questions concerning the issues addressed in the NAVSEA Inspector General's [IE] Office's investigation. My duties as the NAVSEA IG have not directly involved me in the negotiation, award or administration of submarine contracts or program management. I do not claim to be an expert in those areas. If we have fraud-waste problems in those areas, the Navy shares your interest and welcomes your assistance in identifying those problems and rectifying them. As the NAVSEA IG, I am committed, as I know you are, to finding and eliminating fraud, waste and abuse wherever it may exist.

I have with me information, some of which I believe is attached to my statement, that responds to your request and I'll do my best to answer the additional questions relative to those issues.

I will ask your indulgence in any area where I may not be fully qualified and request that I may be able to provide, as necessary, written answers for the record at a later date to any specific questions you may wish to pose.

Let me make it clear that we want to answer all your questions fully and comprehensively to your satisfaction.

NAVY SHIPBUILDING PROGRAM

If I might, Mr. Chairman, let me make some general statements about the Navy shipbuilding program.

Cost-sensitive management and sound judgment are the Navy's driving principles for executing the Nation's naval force buildup. Competition is the cornerstone of our business strategy, as competition is the best tool we have found to obtain lower costs, improved contractor performance, and a strengthened industrial base. The Navy is proceeding on a deliberate basis to introduce second production sources for major acquisition programs in order to expand the industrial base and produce real competition which will help eliminate production monopolies.

In fiscal year 1984 the Navy bought over 86 percent of its ships competitively, and I think you know how that compares to the previous years. More than 90 percent of ships to be built or converted in this year's current 5-year plan will be procured competitively; in fact, virtually every type of ship except nuclear-powered aircraft carriers and Trident ballistic missile submarines is now being competitively acquired. As I will discuss later, pressures are being brought to bear to introduce competitive leverage to the Trident program. I think that's very important. The Navy is confident that it has the right business posture for the future in shipbuilding, a major segment of the Navy budget, and in shipboard weapons and equipment as well.

We have allowed more contractor participation in weapon systems design and have benefited through our expanded use of fixed price incentive contracts. All fiscal year 1984 shipbuilding contract awards were either firm fixed price [illegible] firm fixed price incentive with equal sharing of cost savings or cost growth up to the ceiling. Under these 50-50 shareline arrangements, which started with the SSN-721 in 1981, contractors are rewarded for underbudget performance and penalized by sharing cost growth up to the contract ceiling and bearing all cost growth above that ceiling. We are continuing that strategy.

The performance of our shipbuilders to build and deliver on schedule looks good.

A few years ago, as you know, the lion's share of SSN-688 class submarine contracts were going to the Electric Boat Division of General Dynamics Corp. We began to see that the lack of new submarine construction awards at Newport News Shipbuilding & Drydock Co. was causing a loss of key tradesmen and skills that would ultimately result in the loss of new submarine construction capability at that yard.

In adhering to a policy of maintaining a second source for national defense while keeping alive the specter of competition, the Navy pursued a strategy of splitting contract awards, with one yard receiving only a minimum quantity to ensure work-force stability and skill retention. There remained, however, a real incentive to drive costs down to capture the larger segment of that contract award.

With an advent of the Navy's insistence on fixed price incentive contracts, 50-50 cost overrun sharelines and tighter contractual terms—and those are very key—the submarine construction competitive posture of Newport News improved and their loss of productivity from a vast gap in production has been overcome. As I'll point out in a minute, they won three ships in the fiscal year 1985 awards. Newport News continued to make capital investments to improve their competitive position even further.

This past year, we saw a revitalized submarine construction industry. Intense competition has led both yards to achieve revolutionary breakthroughs in production technology and facilities. Improved work performance, increased capital investment and more efficient fabrication techniques are expected to substantially shorten submarine construction times.

The results: for the fiscal year 1985 shipbuilding awards, Newport News got three of the four 688 class submarines that I mentioned a few minutes ago.

The Navy has executed the shipbuilding programs approved by Congress in a way that promotes innovation, reduces costs, and shortens delivery time. The shipbuilding industry has been very creative in both technical and managerial advances. Recent years have been truly a renaissance for competition and innovation in naval shipbuilding. This trend is one we plan to continue and keep on a sound businesslike basis.

The Navy has embarked on an effort to bring competition in construction of Trident submarines. As you know, we tried this in the early years without success. To date, Electric Boat Division of General Dynamics Corp. has been the sole builder of this class of nuclear submarine. Recently, the Naval Sea Systems Command has inquired of Newport News Shipbuilding & Drydock Corp., the only other builder of nuclear-powered attack submarines, whether it would be interested in construction of Trident submarines and, as a means of getting an introduction into this new submarine, whether it would be interested in performing a post shakedown availability of our latest Trident submarine. We are now awaiting their response.

I would also like to say that Secretary Lehman and the Navy Department share the Department of Defense's (DOD), the Congress' and the American taxpayers' concerns that all of our defense appropriations be spent efficiently and wisely. The Department of the Navy—and I feel particularly qualified to speak on this issue because of my position—has made great strides in educating its personnel, rooting out and punishing those people responsible for fraud, waste and abuse.

PREVENTIVE MEASURES

I speak now particularly from my experience as the IG, significant preventive measures are now in place to counter fraud, waste and abuse. Some of those are being undertaken by managers DOD-wide, while some of those are within my purview as the IG.

The first of these involves a number of management initiatives. One is the BOSS program that you're very familiar with, "Buy Our Spares Smart." It involves working with suppliers and parts contractors, examining sole-source relationships, locating alternative sources, and reducing barriers to competition for spare parts by identifying and eliminating proprietary data requirements. Last year the Navy broke out over 100,000 of these items from the prime contractor for competition or for direct buy from the manufacturer for an estimated saving of $1.2 billion.

Better internal controls are something that we are very concerned about. These are controls that each organization uses ordinarily as the normal part of its management to safeguard its resources, make sure its information is reliable and accurate, assure adherence to laws and regulations, and promote economy and efficiency of its operations.

The responsibility for these controls lies with the chain of command, the commanding officer down to every individual within the activity or command.

Inspections in my world are another measure that I think is a very key measure against fraud, waste, and abuse. Inspectors look at how effectively an activity is performing its mission and review compliance with important directives. We find inspections useful because they reveal existing management deficiencies which should be corrected, and they also locate potential problems because people know that they're going to be looked at periodically.

In my own organization, we have adopted a new philosophy in terms of inspections. We have gone from a reactive, compliance oriented inspection to a more aggessive approach which stresses mission accomplishment, effectiveness, and readiness—that is, what the activity is supposed to be doing and accomplishing. We are going to see long-term improvements in my view in NAVSEA management as a result of that effort.

Audits, of course, are very important. I have the figures here. During the first 6 months of fiscal year 1985 we had 8,491 DOD internal audits that resulted in potential savings of $1.6 billion. At the same time, Defense Contract Audit Agency [DCAA] in looking at contracts identified an additional $2.8 billion in savings of contract costs.

I would like to mention in passing the hotline because the hotline has also given us some success. There are some misgivings about the hotline, but overall it has helped us find fraud, waste, and abuse. We found in looking at hotline cases not only do we sometimes substantiate the allegations but the allegations lead us to other areas that have fraud, waste, and abuse which we might not have found otherwise. The figures are for 1984; in the Navy we had 891 allegations and of that number 26 percent were substantiated.

CRIMINAL CASES

Finally, just a few words about the success we've had when we've found criminals. In the first 6 months of fiscal year 1985, Department of Justice (DOJ) attorneys obtained 468 convictions, and over $37 million in fines, restitutions, and recoveries; 236 suspensions and debarments of DOD contractors in that same period. In my view, that sends a very clear message to those people who want to defraud the Government, both inside and out, that it doesn't pay.

In conclusion, Mr. Chairman, I would like to say that the Navy shares your concern for an efficient, competitive and cost-conscious shipbuilding program. The competitive procurement of 10 SSN-688 attack submarines over a 3-year period is in its final stages. I hope you will understand that because of the ongoing competition certain of the information that you requested, specifically man-hour to complete estimates on recently awarded SSN-688 submarines, cannot be released to the subcommittee without restriction because of its business-sensitive nature.

PRICE INCREASES

Senator PROXMIRE. Thank you very much, Admiral Campbell.

I might say in answer to my questions, if Admiral Cantrell would like to step in, that would be very welcome too.

In the staff report on the Trident and attack submarine program, it's concluded that there are large real price increases in the ships purchased in 1981 through 1983, those 3 years. That was after taking inflation into account and factors such as design changes, equipment improvements, and breaks in production.

Do you agree or disagree that large real price increases took place?

Admiral CAMPBELL. I disagree.

Senator PROXMIRE. All right. Explain why.

UNREALISTIC PRICES

Admiral CAMPBELL. I think to begin with, two things really didn't come out in the reports that I heard. The number one thing is prior to 1980 we were buying—the pricing probably to some extent by the Government but certainly by the contractors was not realistic. There's no question but what we had certain contract buy-ins on the SSN-719 and the SSN-720. Contractors were trying to be extremely optimistic and yet remember back in that period of time there wasn't a lot on their plate and there was not much commercial business, government had a relatively small number of contracts out.

There were restraints on the Government to make those contracts come in on budget. The Government wanted costs to be low. They were optimistic. The contractor looked at them and wanted to do the same thing. During that period of time, the contractor was playing with a shareline that was not 75-25, which is the figure I heard mentioned earlier, but with sharelines which ranged between 95-5 and 85-5.

So what the contractor was doing was saying, "I hope I meet that target cost but if I don't, then I've got an incentive range up to about 130 to 145 percent which I can at least share that cost with the Government with the Government paying the larger part of the cost.

So during that period of time those costs were not realistic. We looked at that. I have a report with me put out by the Comptroller General which tells you exactly what I've just told you, that the costs weren't realistic. Those weren't the real costs of those submarines, that's one of the main factors we've looked at.

The second thing that I heard mentioned that is not accurate is that they are not the same ships. For instance, in the Trident program, we're talking about a major alteration like D-5 which adds significantly to the capability of our Trident submarine. The cost of adding that capability is significant. And when we're talking about SSN-688's we're talking about SUBACS, a new combat system. We're talking about an enhanced hull design. We're talking about electronics. We're talking about a capability which I can't discuss for operating under the ice and we're talking about the new launchers that we retrofitted in contract modifications on the SSN-719 and SSN-720, the pre-1980 ships, that we put on all ships starting with the 1982 ships.

So we're talking really about apples and oranges. That's the main thing I would say.

Now to go to the other distinctions, let me address Trident first. In Trident, we're looking at the SSBN-733 Trident reflected——

Senator PROXMIRE. Could I just interrupt at this point because you've covered several points here, I'm going to ask Mr. Kaufman, our general counsel, as you know, has worked very hard on this for a number of months and has worked primarily with Navy supplied material that comes from the Navy. So I'm going to ask him to follow up.

Mr. KAUFMAN. Admiral, you were mentioning the fact that prices prior to 1980 tended to be unrealistic.

Admiral CAMPBELL. That's correct.

Mr. KAUFMAN. Are you including the Trident submarine in that statement or just the attack submarines?

Admiral CAMPBELL. I am including both classes. Obviously, we have a difference. The Trident submarines were not competed after group I whereas the SSN-688's were. But again, I go back to a general business situation that occurred at the time. The budget was down. The Navy was putting heat on the contractors to try to meet budget figures. There wasn't a lot of business out there. The contractor was trying to be very optimistic assuming everything was going to go right, which is a bad assumption in shipbuilding contracts, but making that assumption was not so risky because in that Trident contract in particular, we got very close to a cost contract in that the ceiling as I recall was something around 145 percent, the Government's shareline over target ranged between 85 and 90 percent, and even if he didn't meet his cost target, the cost to him after he exceeded target up to the 145 percent ceiling was only 13 percent of the costs incurred.

Mr. KAUFMAN. Are you saying that the Trident submarines awarded prior to 1981, let us say, were buy-ins?

Admiral CAMPBELL. No.

Mr. KAUFMAN. Well, you're saying that the prices were unrealistic. In what sense were they unrealistic since these were negotiations between a large defense contractor and the Navy? They were sole-source negotiations. There was no competition driving down prices or bids in the case of the Trident. So in what sense was the price unrealistic?

Admiral CAMPBELL. Well, they were unrealistic in the sense that I mentioned earlier. There was an effort on the part of both the contractor and the Government to be very conservative because of the conservative defense budget that we had at that time.

Second, we're talking about a submarine that had never been built before. Probably the best answer to your question is, as you're well aware, the initial estimate on man-hours for the SSBN-726 submarine was—Admiral Cantrell can correct me if I'm wrong—something around 13 or 14 million man-hours. What did it ultimately cost? 27 million man-hours. We went along using those estimates not knowing they were wrong until we got to the SSBN-727 class submarine. That's the first time that we had any real data as to what the man-hours were other than our estimates and speculations on a ship that had never been built and the world had never seen.

BUY-INS

Mr. **KAUFMAN**. The Navy has previously concluded that the attack submarines SSN-719 and SSN-720 which were awarded in 1979 were buy-ins.

Admiral **CAMPBELL**. That's correct.

Mr. **KAUFMAN**. Do you agree with that?

Admiral **CAMPBELL**. I agree with that.

Mr. **KAUFMAN**. Do you agree then that in stating that other 688 submarine prices were also unrealistic, that the previous 688 class submarines prior to 1979 were also buy-in contracts?

Admiral **CAMPBELL**. I don't think the SSN-719 and SSN-720 were—by that time we had enough data to realize that the contractor couldn't make the performance that he thought that he could; again, for some of the similar reasons I mentioned on Trident—a new class of submarine.

Mr. **KAUFMAN**. Were the early submarines buy-ins?

Admiral **CAMPBELL**. I don't think that they were buy-ins but I think they were overly optimistic—I think we were overly optimistic on our estimates, as was the contractor, on what it was going to take him to perform those contracts. They certainly were not real buy-ins.

Mr. **KAUFMAN**. Now in the contract awarded to General Dynamics for the 733 Trident which was awarded in January 1981, there was an option price for the next two submarines.

Are you saying that the price of the Trident awarded in 1981 was unrealistic?

Admiral **CAMPBELL**. As I mentioned earlier, when we got to SSBN-727 we first started getting realistic data on what the man-hours were really going to be to build those submarines. We cranked that figure in on the SSBN-722 to make it a better figure. When we got past SSBN-733, we again looked at what progress we had shown to verify or show that our assessments of where we were going on SSBN-727 were inaccurate. We looked at that again to see what that should lead us to in SSBN-734. We found in our view that we still had not quite gotten there. In addition, SSBN-734 was D-5, and D-5 means big bucks.

Mr. **KAUFMAN**. I will ask about the D-5 in one second, but let me understand what you're saying. You're saying—or are you saying—that the price for the SSBN-733 was unrealistic?

Admiral **Campbell**. The price of the SSBN-733 I would not say was accurate. I would not say it was unrealistic either.

OPTION PRICE

Mr. **Kaufman**. You recognize, of course, that in that contract there was an option for the SSBN-734?

Admiral **Campbell**. That's correct. But whenever you have an option like that, in essence, you have to look at what you're going to be putting into the SSBN-734 and if you really start over with that base figure from the option, and then you go back—the SSBN-733 was in one year's dollars, you go to SSBN-734 which was in a different year's dollars and you crank that on, and in addition you crank on to that what you're going to do to the SSBN-734 that you didn't do to the SSBN-733 which to a great extent was D-5.

Mr. **Kaufman**. Now the D-5 missile was added to the 734. Was that done with a contract modification?

Admiral **Cantrell**. Yes, sir. I will answer that. At the time of award of the SSBN-735, there was a modification to the SSBN-734 contract to include the D-5 weapon system.

Mr. **Kaufman**. For your information, the study that was presented by the staff considered the contract price for the 734 which was stated on the contract without the added amount for the D-5 missile. So that the analysis of the submarine contract prices was done without regard to the add-on cost of the missile and therefore considers the cost of the submarine against the option price for the same submarine with the same equipment.

In that case, it would not be a matter of apples and oranges, would it?

Admiral **Cantrell**. I understand what you're saying and I would like the committee's indulgence to let the Navy address that because in looking at your chart I note that the unit price that's listed is the D-5 unit price and there's a footnote relative to the 12-month extension that's associated with that. So we would like, if you would agree, that the Navy provide a detailed breakdown on the transition between C-4 and D-5 to account for those dollar differences.

[The following information was subsequently supplied for the record:]

Comparison of SSBN-734

[In millions of dollars]

	N00024-80-C-2201	
	Lead ship—SSBN-733	Option ship [1]—SSBN-734
Target cost	$350.8	$350.5
Target profit	50.2	50.2
Target price	401.0	400.7

COMPARISON OF SSBN-734—Continued

[In millions of dollars]

	N00024-81-C-2134	
	Lead ship—SSBN-734	D-5 Mod—on 734
Target cost	$444.2	$25.6
Target profit	79.5	4.5
Target price	523.7	30.1

[1] Option never awarded

Difference in target cost of the SSBN-734 as a C-4 ship as the option to C-2201 and its price as a C-4 ship as the lead ship in C-2134 is $93.8M.

Elements of the $93.8M:	Million
Non-recurring costs due new contract, increase of approximately 400K M/Hrs	$7
Adjustment due to contract base date change, increase of approximately 13 percent on Labor	38
Increase of approximately 15 percent on Material	27
Adjustment in negotiated man-hours, increase of approximately 1.2M M/Hrs	22

SUBACS

Mr. KAUFMAN. Certainly. Now as far as the SUBACS is concerned, what was the first attack submarine that the first SUBACS was added to?

Admiral CAMPBELL. That was the fiscal year 1982——

Admiral CANTRELL. The SSN-751.

Mr. KAUFMAN. For your information, I might point out, Admiral, that the staff analysis presented earlier looked at the submarines prior to the SSN-750. It looked at the 721 through the 724 and did not consider the submarines with SUBACS included in the contract based price.

The comparison of submarines therefore was not skewed by the addition of the SUBACS system.

Admiral CANTRELL. Yes, sir; I understand. I think what Admiral Campbell is saying and, of course, I'm saying it also, without the list of military improvements that go with each hull, and every single one of those hulls progressively has an increased military capability going all the way back to 719 and later, a progressive significant change, and if the staff study has reflected those, we haven't had the opportunity to see that you've considered the underice capability, the special fighting features and the other things that are incorporated in each of those ships.

Mr. KAUFMAN. We have attempted to do that.

Admiral CAMPBELL. Well, we obviously have a divergency in figures. We have not made the same estimate that you have taking all those things out, but we have tried to identify in percentages exactly where those increased costs came in. And on the Trident, again, the Trident figures would show that using a fiscal year 1980 base date on the 733 as opposed to a fiscal year 1981 base date on the 734, together with increased learning on what it was really going to cost—in other words, more man-hours, which is a substantial figure, plus D-5, the difference in the base years alone accounts for 13 percent and the other two things that I talked about amount to a total of about 14 percent, which get us to our figure which shows there was a 26 percent differential in price.

Senator **Proxmire**. Admiral Campbell, the report says that the attack submarine purchased in August 1981 also experienced a large real price increase and that part of it occurred when at the end of negotiations Mr. Sawyer surprised everyone with a 50-50 shareline provision.

How do you explain the large real price increase and Mr. Sawyer's behavior, the $24 million increase for the same submarine?

Admiral **Campbell**. Well, you're talking about the increase in price which occurs between the bid that Newport News made competitively and what they ultimately bought the three submarines for?

Senator **Proxmire**. No, it's an increase that occurred in a 2-day period at the end of negotiations.

Admiral **Campbell**. I don't know that that increase occurred. I was not privy to those discussions or negotiations. I can only address overall costs.

Senator **Proxmire**. Well, the data we get are from the Navy. This isn't data from any other source.

Admiral **Campbell**. What I'm saying is I don't have any data that says that in 2 days it went up that much.

Senator **Proxmire**. Well, will you answer that for the record?

Admiral **Campbell**. Yes, sir, I'd be happy to.

[The following information was subsequently supplied for the record:]

Submarine Price Increase

The August 5, 1981, meeting between Secretary Sawyer, other Navy officials, and Newport News Shipbuilding representatives, was necessary to reach agreement on three outstanding issues that were preventing the conclusion of negotiations for the SSN-721, 722, and 723 construction contract: the contract incentive shareline; terms and conditions concerning repairs to nuclear Government Furnished Equipment; and realistic and achievable contract delivery dates. The target price of the contract reflects consideration for final resolution of these issues, which transferred substantial cost and performance risk to Newport News Shipbuilding without any increase in the Government's ceiling price cost liability. The negotiation of this contract's 50/50 incentive shareline is particularly noteworthy, as it was a significant departure from the 80/20 cost sharing provisions of previous SS-688 Class construction contracts. The 50/50 shareline greatly increased Newport New's share of any exposure. This agreement was an important first step in reaching a larger Navy objective of emphasizing shipbuilding industry performance and cost consciousness by distributing risk equally between the Government and its contractors.

VERTICAL LAUNCH SYSTEM

Senator **Proxmire**. Now, Admiral Campbell, the vertical launch system is discussed in the report. In 1982, the Navy decided to modify the two attack submarines purchased from General Dynamics in 1979 with the vertical launch system.

What was the cost of that modification?

Admiral **Campbell**. The cost of the modification I guess was not adequately submitted to you.

Admiral **Cantrell**. In the information which we submitted last evening, the VLS contract modification for both the SSN-719 and SSN-720 is broken down as follows: Cost, $23.6 million; profit, $4.7 million; price, $28.3 million.

Admiral CAMPBELL. Which I might add, tacking those figures on to the cost of the contracts brings you up to the current estimated cost of $330.2 million with an estimated profit of $27.4 million; current estimated price, $357.6 million; and current escalated cost, $449.6 million; with an estimated profit of 5.4 percent.

Senator PROXMIRE. Now some Navy officials believe that the vertical launch system modification was intended as a bailout to General Dynamics so that it would make a profit on the two 1979 submarines, the SSN-719 and 720.

How do you respond to that?

Admiral CAMPBELL. Those were fully negotiated and definitized contract modifications. I think the contract figure that I just gave you on the overall profit that they obtained are——

Senator PROXMIRE. I accept that, but my question is, would they have made a profit without the VLS modification? Does that make the difference?

Admiral CAMPBELL. I think they would, certainly.

Senator PROXMIRE. You said it was a buy-in. How could they make a profit on a buy-in?

Admiral CAMPBELL. Well, they make a profit ultimately on changes running the cost line out up until ceiling price. It would not have been much of a profit.

Mr. KAUFMAN. Are you saying, Admiral, that after the Navy concluded that the submarines were bought under a buy-in contract that the Navy gave them change orders which enabled them to get well from their difficulties?

Admiral CAMPBELL. I'm not saying that. I'm saying that undoubtedly there were some changes in it and there were probably some profits on those changes. I don't think the changes were negotiated in order to give them the ability to get well on their contract. Obviously, it would if they made some profit, add some profit to the contract.

Senator PROXMIRE. If it was not a buy-in, why weren't similar VLS modifications added to the other submarines that were underway in 1982 and why was the design used for the 1979 ship discarded for later ships?

Admiral CAMPBELL. I don't understand the question. We do have VLS in later ships.

Admiral CANTRELL. VLS is going on all the ships subsequent to those, the variations in the way the tubes were mounted was the result of two competing designs and we selected the one which was cheaper and more effective.

Mr. KAUFMAN. Could you state how many attack submarines were under construction at General Dynamics at the time that the VLS modification was awarded for the SSN-719 and SSN-720?

Admiral CAMPBELL. I can't speak to that. I don't know whether Admiral Cantrell can or not.

Admiral CANTRELL. I can't do it off the top of my head. We can certainly go back and take a snapshot in time and provide that for the record.

[The following information was subsequently supplied for the record:]

SUBMARINES UNDER CONSTRUCTION; MODIFICATION OF VLS

Ten submarines were under construction at Electric Boat on January 22, 1982, when Vertical Launch System Design work was added to the SSN-719 and SSN-720 construction contract, No. N00024-79-C-2720, by modification P00005: SSN-703, SSN-704, SSN-705, SSN-706, SSN-707, SSN-708, SSN-709, SSN-710, SSN-719, and SSN-720.

Mr. **KAUFMAN**. Weren't there six or more other attack submarines under construction at the same time?

Admiral **CANTRELL**. I don't know that information. I think we'd better provide it for the record to make sure we're accurate.

[The following information was subsequently supplied for the record:]

ATTACK SUBMARINES UNDER CONSTRUCTION

The VLS modification for the SSN-719 and 720 was definitized on 6 May 1983. At that time Electric Boat had seven SSN-688 Class Ships under contract for construction.

Mr. **KAUFMAN**. Assuming there were several other submarines under construction at the same time, how would you explain the fact that the VLS modification was only awarded on the buy-in contract and not on the others?

Admiral **CAMPBELL**. It probably has a great deal to do with how far along they were in completion and how easy it would be to put VLS in.

Admiral **CANTRELL**. If I could amplify that from the technical and engineering standpoint, when we have major modifications such as this we do not introduce them until the design is mature enough to not impact the shipbuilding process. This was a high-priority military change. The design was mature enough. It fell in line with the SSN-719 and the SSN-720 and all subsequent ships.

Had it been the SSN-722 and the SSN-723, they would have been the ones picked.

Mr. **KAUFMAN**. If it was a high-priority change, wouldn't it have been made on the other submarines under construction at the time?

Admiral **CANTRELL**. Only if construction progress was at such a point that the modification could be inserted at that late point without delay. It's strictly a function of the progress of the ship and the ability to change foundations, cabling, sound isolation, volume, flow, air conditioning, those kinds of things. In the other ships it would have been a tremendous cost, and delayed construction to modify to backfit VLS into the ships.

Mr. **KAUFMAN**. In the past the Navy has even brought ships back after they were delivered for their first overhaul and retrofitted high-priority equipment changes into them. Was this done with any of the previous submarines concerning the VLS?

Admiral **CANTRELL**. It has not been done yet because none of the ships that would be capable of carrying it have come due for overhaul.

Mr. **KAUFMAN**. Is there any plan to do so?

Admiral **CANTRELL**. That's constantly under review and it will be decided in the budget process.

Mr. **Kaufman**. Is it correct that the VLS design used for the SSN-719 and SSN-720 was discarded with respect to later VLS installations?

Admiral **Cantrell**. As I mentioned earlier, the VLS capability has not been discarded. The details of the design as it has matured have been changed somewhat and it's strictly in the structural arrangement and strength and stress calculations.

Senator **Proxmire**. Admiral, how much profit do you estimate General Dynamics will make on the two 1979 submarines?

Admiral **Campbell**. On which submarines, sir?

Senator **Proxmire**. The two 1979 submarines?

Admiral **Campbell**. SSN-719 and SSN-720?

Senator **Proxmire**. That's right.

Admiral **Campbell**. I think those figures were also provided, were they not? I don't have that figure with me.

Senator **Proxmire**. My problem is we received this only an hour before the hearing and we've had difficulty getting our ducks in a row because we had such little time.

Admiral **Campbell**. I apologize for that but we received the questions on January 6 and I did not get the information I have until yesterday and it's——

Senator **Proxmire**. Also, some of the information is marked business sensitive, so we want to be very careful in what we reveal.

Admiral **Campbell**. Yes, sir, particularly man-hours on 688 contracts. I can get you an answer to the question you asked very easily. I don't have it in the materials I have here.

Senator **Proxmire**. You don't have it here?

Admiral **Campbell**. No.

Senator **Proxmire**. Well, get it for the record as soon as you can.

[The following information was subsequently supplied for the record:]

ELECTRIC BOAT PROFITS

Electric Boat will earn a total profit of approximately $27.4M on the SSN-719 and 720.

Senator **Proxmire**. In my letter to you I asked for the figures that Newport News bid for the SSN-721, 722 and 723 when they were under competition. What are those figures?

Admiral **Campbell**. Let me give you an answer that gives you those figures and some more information.

The March 1980 Newport News proposal was for two ships at approximatley $147 million per ship. That's the one that was put up whenever they were making competitive bids. This per ship price was the basis for the subsequent negotiation of a three-ship contract awarded to Newport News in August 1981.

If you'd like, I'll give you the differences between those figures and the figure that ultimately came out. The figure itself, if you look at the total contract figure for the March——

Senator **Proxmire**. Why don't you give us the rest of that for the record? That would be helpful.

Admiral **Campbell**. All right.

[The following information was subsequently supplied for the record:]

NEWPORT NEWS PROPOSAL

The March 1980 Newport News proposal was for two ships at $147 million per ship. This per ship price was the basis for the subsequent negotiation of a three ship contract awarded to Newport News in August 1981. The differences between the competitive March 1980 Newport News proposal and the eventually negotiated target costs of the three ships are principally as follows:

1. The March 1980 proposal was priced in September 1979 dollars, whereas the awarded contract was priced in September 1980 dollars. Changing the base month merely shifted some escalation costs to target costs and has no impact on final cost to the Government. This base month change increased the target cost by $45.741 million.

2. Newport News had not been awarded an SSN 688 contract since 1977. This lapse of four years in award of a ship resulted in a break in production. The optimum interval between submarine deliveries is normally six months, and the March 1980 proposal was predicated on such an interval between construction of ships in progress and the first of the two submarines. The awarded contract reflects a 23 month interval which impacted major cost elements, such as labor man-hours, due to loss of production continuity between ships. $14.145 million was included in the NAVSEA target cost for the break in production.

3. Additional specification requirements added after the March 1980 proposal increased the target cost by $5.902 million.

4. Increased requirements by the Occupational Safety and Health Administration increased target costs by $8.383 million.

5. Overhead and other rate changes, including changes to cost of money calculations, prescribed for use by Cost Accounting Standards, increased target cost by $34.787 million. It is likely that the preponderance of these costs would have been overrun costs under the March 1980 Newport News offer.

6. Additional non-recurring costs totalled $4.844 million.

7. A net target cost increase $17.797 million resulted from (a) changing the construction period from 55 months to 64 months, (b) imposing stringent anticlaims requirements of clauses such as "Drawings and Other Data", "Insurance", and "Notification of Changes", and (c) negotiation reductions. The revised insurance clause clearly made the contractor fully responsible for defective workmanship and defective materials.

The following summarizes the estimated changes to target cost.

[In millions of dollars]

	Target Cost
NNS March 1980 Competitive Offer	
Extrapolated for Three Ships	$441.434
Base Month Change	45.741
Production Break	14.145
Specification Differences	5.902
OSHA Requirements	8.383
Rate and COM Changes	34.787
Additional Non-recurring	4.894
Delivery Change, Anti-Claims Clauses	17.797
Other	(.583)
Total	$572.500

The reasonableness of the three ship target price for the August 1981 contract can be confirmed by comparisons with the target prices of contracts for two submarines awarded on a price competitive basis in April 1982, eight months after the three ship award. All of these ships were priced in September 1980 dollars and are therefore directly comparable. The per ship prices for the April 1982 awards were $239.8 million for Electric Boat and $236.4 million for Newport News. The per ship price for the August 1981 award to Newport News was $224.7 million. The April 1982 awards included the Tomahawk Vertical Launch System (VLS) which was not included in the August 1981 award. Adjusting the April 1982 prices to eliminate VLS, and adjusting the August 1981 price to eliminate costs associated with the production break and other non-recurring costs, results in an August 1981 non-competitive price of approximately $217.5 million and April 1982 competitive prices of approximately $225.6 million for Electric Boat and $222.5 million for Newport News. The price for the non-competitive three ship award to Newport News, therefore, compares favorably with the competitive prices.

Newport News' performance under this contract plan also indicates that these ships were not unreasonably priced. The total final costs of SSNs 721, 722, and 723 are projected to exceed target costs by approximately 6.0 percent. This current experience indicates the initial pricing for SSNs 721, 722, and 723 was very accurate for a complex shipbuilding program extending over six years.

PROGRESS PAYMENTS

Senator PROXMIRE. Now the GAO reports that the Navy told it that overprogressing occurred on the Tridents and 688 class submarines prior to March 1982.

Were you aware of the overprogressing and why didn't the Navy take action before 1982?

Admiral CAMPBELL. I think again we're faced with responding to a report that we had essentially none of the information that GAO gave us. There are some things that they did not talk about while they were here. For instance, certainly———

Senator PROXMIRE. Let me just interrupt, Admiral, and say that what I said was the GAO reports that the Navy told it—the Navy told it—I presume your operation told it, that overprogressing occurred on the Tridents and 688 class submarines prior to March 1982. So apparently the Navy had that information and it did not originate with the GAO.

Admiral CAMPBELL. I would say that that's probably accurate and the reason it's accurate is, again, we're dealing with contracts back in that period of time that were estimated to go at something like 13 or 14 million man-hours. They went to 27 million. Everybody played the game for a while and said, "Yeah, we hope you make it. Maybe you've got a chance of making it." It was made along those lines.

Senator PROXMIRE. Why didn't the Navy take action before 1982?

Admiral CAMPBELL. We took action as soon as we were satisfied that the progress payments we were giving them were in excess of what they deserved based on their physical progress. When we did that, what we did was withhold progress payments until they got up to a figure that satisfied our estimate.

I might say, you know, we're talking in terms when you start down this trail you're looking at 30, 31, 32—you get a disagreement of 1 percent, you're talking about many millions of dollars. It was very difficult for the contractor and the Navy to say exactly whether you're at 41 percent progress or you're 40 percent or 42 percent. So as soon as we knew, we corrected them.

Senator PROXMIRE. Well, you're absolutely right about 1 percent meaning many millions of dollars and, of course, that's why we have so many experts working on this.

Do you know how much overprogressing occurred and over what time period?

Admiral CAMPBELL. I don't have those figures; no, sir. I will provide them for the record.

Senator PROXMIRE. Do you have that in your office?

Admiral CAMPBELL. I don't have them in my office but they are available in an office within NAVSEA.

[The following information was subsequently supplied for the record:]

OVERPROGRESSING

This report shows the variance between what was claimed by the contractor as his percent completion for each ship, and what was the actual percent completion during each month starting from February 1980. A positive number represents overprogressing, and a negative number represents underprogressing. The report is based on the actual man-hours to complete the ship, so it represents a "hind-sight" view. For example, overprogressing on the SSBN-726 in February 1980 was 14.44 percent based on what we now know it took to complete that ship, not on what was estimated to complete the ship in February 1980. Also, progress payments were based on the limitation of cost clauses in effect in the contracts. One cannot conclude the contractor was paid 14 percent more than he actually earned.

REPORTED PROGRESS MINUS ACTUAL PROGRESS COMPARISON REPORT(COMPARISON DATA)

MO.YR.	SSN700	SSN701	SSN702	SSN703	SSN704	SSN705	SSN706	SSN707	SSN708	SSN709	SSN710	SSN719	SSN720
280	11.96	15.02	12.62	12.06	8.36	6.85	4.09	2.63	2.14	1.69	1.08	-0.43	-0.03
380	11.89	14.51	12.42	12.09	8.87	6.72	4.15	2.37	1.83	1.30	1.03	-0.04	-0.04
480	11.26	15.59	13.44	12.71	8.69	7.10	3.87	2.92	1.77	2.08	0.99	-0.40	-0.04
580	10.32	14.86	13.70	12.58	9.41	7.19	4.37	2.84	1.88	1.62	1.14	-0.21	-0.06
680	9.03	13.23	12.69	12.07	9.55	6.88	3.86	2.39	1.08	1.21	0.92	0.03	-0.04
780	8.69	12.41	12.10	11.46	9.42	7.56	4.51	2.12	1.60	1.66	0.76	-0.28	-0.05
880	8.41	12.13	12.11	11.64	10.01	7.26	4.16	2.55	0.46	0.35	0.84	-0.92	-0.06
980	6.73	11.26	10.89	10.73	9.39	7.55	4.18	2.24	0.41	0.26	0.71	-1.50	-0.11
1080	6.38	10.79	10.72	10.63	9.79	7.67	4.12	2.67	0.15	0.03	0.82	-1.45	-0.16
1180	4.84	9.53	9.76	9.97	9.13	7.13	4.09	2.41	0.14	0.33	1.48	-1.75	-0.10
1280	4.08	8.96	9.06	9.66	9.60	7.01	3.96	2.46	-0.25	0.20	1.54	-0.80	-0.04
181	2.83	7.59	7.36	7.55	8.14	5.86	2.88	1.57	-0.92	-0.84	1.07	-1.57	-0.23
281	2.07	7.07	7.63	8.71	8.80	7.62	4.24	2.23	-0.38	-0.28	1.72	-0.83	-0.05
391	1.12	5.68	6.91	8.32	8.74	6.54	3.74	1.75	-1.47	-1.40	0.51	-1.02	-0.27
481	0.83	4.36	5.87	7.72	8.98	6.92	4.10	1.97	-1.38	-0.98	0.49	-0.69	-0.24
581	0.06	2.97	4.46	6.33	8.43	6.52	3.93	1.85	-1.09	-1.20	0.42	-0.67	-0.18
681	0.12	1.57	3.39	4.96	7.76	6.21	3.70	1.50	-1.15	-1.53	-0.23	-1.07	0.18
781	0.00	0.88	2.60	3.98	7.89	6.24	4.02	1.78	-1.03	-1.67	-0.21	-0.98	0.15
881	0.00	0.30	2.17	3.06	7.55	5.84	3.99	1.42	-1.06	-2.02	-0.27	-1.14	0.02
981	0.00	0.19	1.39	1.07	6.25	5.26	3.63	1.60	-1.15	-2.27	-0.57	-1.19	0.07
1081	0.00	0.00	0.88	0.22	5.44	4.94	4.01	1.52	-1.15	-2.37	-0.56	-1.13	0.21
1181	0.00	0.00	0.12	0.41	3.94	4.20	3.31	1.17	-1.29	-2.53	-0.73	-1.33	0.15
1281	0.00	0.00	0.08	0.11	2.82	3.29	2.27	0.82	-1.68	-2.86	-1.24	-1.64	0.08
182	0.00	0.00	0.00	0.00	2.21	3.22	2.17	0.83	-1.30	-2.64	-1.15	-1.83	0.19
282	0.00	0.00	0.00	0.00	0.19	3.15	2.35	1.21	-1.07	-2.18	-0.99	-1.72	0.26
382	0.00	0.00	0.00	0.00	2.16	4.12	3.83	2.68	1.21	-0.46	-0.35	-0.32	0.52
482	0.00	0.00	0.00	0.00	1.70	3.60	3.93	3.03	1.47	-0.26	-0.18	-0.48	0.64
582	0.00	0.00	0.00	0.00	0.96	2.89	3.59	2.74	1.37	-0.50	-0.93	-0.85	0.70
682	0.00	0.00	0.00	0.00	0.09	1.83	2.85	2.05	1.12	-0.82	-1.01	-1.08	0.42
782	0.00	0.00	0.00	0.00	0.09	1.50	2.93	1.95	1.17	-0.84	-1.01	-0.87	0.72
882	0.00	0.00	0.00	0.00	0.00	0.81	2.41	1.21	1.29	-1.02	-1.18	-0.74	0.77
982	0.00	0.00	0.00	0.00	0.00	0.04	1.51	1.19	0.93	-1.06	-1.47	-1.06	0.67
1082	0.00	0.00	0.00	0.00	0.00	-0.08	1.52	1.39	1.28	-0.74	-1.32	-1.24	0.71
1182	0.00	0.00	0.00	0.00	0.00	0.16	0.92	0.89	1.18	-0.67	-1.61	-1.61	0.50
1282	0.00	0.00	0.00	0.00	0.00	0.00	0.20	0.47	0.66	-0.93	-1.57	-1.93	0.46
183	0.00	0.00	0.00	0.00	0.00	0.00	-0.15	0.05	-0.18	-1.47	-1.72	-2.24	0.10
283	0.00	0.00	0.00	0.00	0.00	0.00	-0.45	-0.41	-0.29	-1.41	-1.87	-2.01	0.18
383	0.00	0.00	0.00	0.00	0.00	0.00	-0.63	-0.67	-0.59	-1.91	-2.12	-2.85	-0.49
483	0.00	0.00	0.00	0.00	0.00	0.00	0.08	-0.65	0.03	-0.67	-1.40	-2.32	-0.53
583	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.13	0.13	0.12	-0.36	-1.46	-0.16
683	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.51	0.03	-0.41	-0.22	-1.66	-0.55
783	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.05	-0.14	-0.65	0.43	-1.05	-0.40
883	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.17	0.18	0.41	0.92	-0.78	0.02
983	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.42	-0.40	0.61	-0.99	-0.02
1083	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.13	-0.19	0.85	-0.75	0.29
1183	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.01	0.71	1.32	0.30	0.87
1283	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.04	0.72	0.95	0.47	1.17
184	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.26	0.30	0.99	0.41	1.25
284	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.06	0.43	0.81	0.91	1.66
384	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.22	0.07	0.41	0.96
484	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.02	0.28	1.17	1.37
584	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.28	0.38	1.64	1.67
684	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.02	0.04	1.13	1.25
784	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.04	-0.33	2.33	1.88
884	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.13	1.85	2.74
984	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.77	1.34	1.92
1084	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.35	1.66	2.81
1184	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.11	2.25	3.64
1284	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.00	1.63	3.07
185	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.75	2.97
285	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.15	2.71
385	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.41	1.91
485	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.02	2.22
585	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.13	1.76
685	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.00	1.13
785	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.04
885	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.12
985	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.22
1085	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.10

REPORTED PROGRESS MINUS ACTUAL PROGRESS COMPARISON REPORT (COMPARISON DATA)

MO. YR	SSBN726	SSBN727	SSBN728	SSBN729	SSBN730	SSBN731	SSBN732
280	14.44	15.01	9.95	3.56	1.01	0.19	0.05
380	13.89	14.59	9.88	3.95	0.87	0.04	0.05
480	13.76	15.06	10.43	4.27	1.66	0.37	0.00
580	13.06	15.53	10.65	4.71	1.54	0.12	-0.03
680	10.98	13.10	9.91	4.28	1.38	0.20	0.01
780	10.50	13.06	9.52	4.47	1.57	0.21	0.03
880	10.02	12.73	9.80	4.70	1.31	0.02	-0.02
980	8.67	12.24	9.65	5.01	1.07	-0.19	-0.05
1080	8.76	12.07	9.95	5.00	1.74	-0.11	-0.13
1180	7.72	11.20	9.72	5.15	1.36	0.06	0.29
1280	6.52	10.77	9.68	5.23	1.29	0.34	0.46
181	5.35	9.54	8.46	4.52	0.44	-0.40	-0.02
281	4.32	9.84	8.74	5.16	1.93	0.54	0.31
381	3.23	9.36	8.36	4.81	1.44	0.04	0.17
481	2.35	9.07	8.48	5.08	1.68	0.05	0.38
581	1.35	8.14	7.89	4.97	1.65	0.31	0.31
681	1.09	7.06	7.27	4.89	1.42	0.14	0.29
781	0.69	6.73	7.05	5.03	1.60	0.34	0.47
881	0.06	6.37	6.82	5.00	1.39	0.30	0.29
981	-0.20	5.08	5.82	4.34	1.35	0.42	0.31
1081	-0.00	4.32	5.46	4.34	1.76	0.19	0.39
1181	0.00	3.39	5.11	3.71	1.48	-0.02	0.29
1281	0.00	2.03	4.46	3.29	1.11	-0.18	0.16
182	0.00	1.43	4.02	3.25	0.98	-0.02	0.32
282	0.00	0.39	4.05	3.57	0.89	0.28	0.61
382	0.00	-0.20	3.13	1.71	1.18	-0.40	0.54
482	0.00	-0.44	3.01	1.50	0.68	-0.23	0.82
582	0.00	-0.21	2.99	1.55	0.87	-0.03	1.04
682	0.00	-0.61	1.91	1.15	0.69	0.18	0.88
782	0.00	-0.78	1.59	1.23	0.79	-0.11	1.05
882	0.00	0.33	1.28	1.05	0.86	-0.19	1.15
982	0.00	0.00	0.49	0.61	0.14	-0.56	0.84
1082	0.00	0.00	0.01	1.16	0.36	-0.36	0.94
1182	0.00	0.00	-0.53	0.63	-0.23	-0.53	0.92
1282	0.00	0.00	-1.22	0.35	-0.26	-0.33	0.72
183	0.00	0.00	-1.51	-0.19	-0.76	-0.54	0.79
283	0.00	0.00	-1.18	-0.62	-0.77	-0.54	0.56
383	0.00	0.00	-1.30	-1.16	-0.97	-0.87	0.24
483	0.00	0.00	-0.98	-1.26	-0.21	-0.47	0.28
583	0.00	0.00	0.11	-1.14	-0.06	-0.21	0.52
683	0.00	0.00	0.00	-1.47	-0.57	-0.51	0.27
783	0.00	0.00	0.00	-1.14	-0.24	-0.12	0.37
883	0.00	0.00	0.00	-0.98	-0.19	0.24	0.47
983	0.00	0.00	0.00	-1.29	-0.77	-0.55	0.42
1083	0.00	0.00	0.00	-0.87	-0.92	-0.63	0.46
1183	0.00	0.00	0.00	-0.53	-0.56	0.23	1.10
1283	0.00	0.00	0.00	-0.59	-0.85	0.29	1.00
184	0.00	0.00	0.00	0.11	-1.00	-0.46	0.76
284	0.00	0.00	0.00	0.00	-1.02	-0.28	0.89
384	0.00	0.00	0.00	0.00	-1.65	-0.77	0.24
484	0.00	0.00	0.00	0.00	-1.33	-0.17	0.50
584	0.00	0.00	0.00	0.00	-1.37	-0.04	0.84
684	0.00	0.00	0.00	0.00	-1.22	-0.74	0.38
784	0.00	0.00	0.00	0.00	-0.91	-0.87	0.69
884	0.00	0.00	0.00	0.00	-0.88	-1.14	0.97
984	0.00	0.00	0.00	0.00	0.04	-0.92	0.34
1084	0.00	0.00	0.00	0.00	0.00	-0.64	0.66
1184	0.00	0.00	0.00	0.00	0.00	-0.59	1.21
1284	0.00	0.00	0.00	0.00	0.00	-0.85	-0.23
185	0.00	0.00	0.00	0.00	0.00	-1.03	-0.01
285	0.00	0.00	0.00	0.00	0.00	-0.61	-0.46
385	0.00	0.00	0.00	0.00	0.00	-0.71	-1.54
485	0.00	0.00	0.00	0.00	0.00	0.11	-1.06
585	0.00	0.00	0.00	0.00	0.00	0.00	-1.11
685	0.00	0.00	0.00	0.00	0.00	0.00	-1.75
785	0.00	0.00	0.00	0.00	0.00	0.00	-1.82
885	0.00	0.00	0.00	0.00	0.00	0.00	-1.21
985	0.00	0.00	0.00	0.00	0.00	0.00	-1.42
1085	0.00	0.00	0.00	0.00	0.00	0.00	-1.23

Senator **Proxmire**. Did it extend back as far as 1980? GAO told us that. Can you deny that?

Admiral **Campbell**. I can't deny that; no, sir.

Senator **Proxmire**. Isn't it possible that any overprogressing before 1982 was based on false and misleading statements provided by General Dynamics to the Navy?

Admiral **Campbell**. I don't think so. We go again back to the same scenario that I talked about earlier. Everybody hoped they could do the job in 13 million man-hours. We hoped they would. We had the data so it wasn't false. We knew what they were basing it on. We hadn't built a ship like this, so——

MAN-HOURS

Senator **Proxmire**. Let me just question you on the stark point that was made so well by the General Accounting Office. When General Dynamics told the Navy in March 1982 that it had spent 12.6 million man-hours on ships when it actually spent only 1.8 million, wasn't that a false statement and didn't the Navy receive false information?

Admiral **Campbell**. I don't think that was false information. I think they had spent that many dollars and we paid the lesser figure, not the greater figure. Where the discrepancy comes in is we did not agree that that many hours equated with that much physical progress. That's the difference.

Senator **Proxmire**. Well, do you deny that they said they had spent 12.6 million man-hours on ships and that they had actually spent 1.8 million?

Admiral **Campbell**. I don't think that's accurate.

Admiral **Cantrell**. Mr. Chairman, on that point, I would very much appreciate it if the Navy and the GAO could resolve that because the discussion of progress payments, costs, costs incurred, man-hours expended, physical progress as we had here, had some gaps in it and the statement that Electric Boat may have said they spent 12.6 million man-hours in a particular point in time when they spent 1.8 I think we need clarified because that would mean Electric Boat would have had to lay off most of their work force during those 2 weeks to not spend those hours. I think the case is, they spent the man-hours but they did not achieve the progress.

Admiral **Campbell**. We certainly are as surprised at the discrepancy as you are and I, in consonance with what Admiral Cantrell just said, I think that we need to get with GAO and get the figures together.

Senator **Proxmire**. Let me ask Mr. Landicho if he would just come to the table for a moment and comment on this because this seems to me to be a striking—and your colleagues if you wish—difference here.

Did they spend the 12.6 million man-hours on ships, General Dynamics that is, or did they not?

Mr. **Landicho**. The source of that information comes from a Navy document itself—a correspondence—and it shows that the 12.6 they're talking about man-hours and they also relate in that same letter that only 1.8 million hours was actually expended. So this is from the Navy source document itself. It's not a GAO computed number.

Senator PROXMIRE. So General Dynamics is telling the Navy they spent that many man-hours?

Admiral CAMPBELL. Yes, sir.

Senator PROXMIRE. And they admit they did not; is that right?

Mr. LANDICHO. Well, the way that it comes out in the documentation and as we relate in our statement, back in March 1982 this is what EB advances and Supships take exception to it at that point in time and suspends the progress payment. But the Navy's comment about not knowing about the number, that number was certainly available to the Navy because it comes from Navy documents.

Admiral CANTRELL. Mr. Chairman, if I could, I have no disagreement with what he said because he said 12.6 million earned man-hours versus 1.6 expended. Those are two different things. In the calculation of progress payments, those are expended man-hours.

Senator PROXMIRE. Is that your understanding, that the explanation of this according to Admiral Cantrell is that you're talking about 12.6 million is the amount earned and 1.8 is the amount expended. Do you accept that?

Mr. LANDICHO. Yes. I believe the context of the 12.6 million—we'll doublecheck that—is in the context of earned hours. That's according to the way they were doing it at Electric Boat. They used this notion of earned value and earned hours.

[The following information was subsequently supplied for the record:]

The process of constructing a submarine involves several thousand individual tasks. Each task has a certain number of labor hours budgeted for its completion.

Labor progress is a major component in the computation of the physical percentage of completion for submarine construction, and is measured by the number of budgeted hours earned to date compared to the total number of hours budgeted. The number of hours actually worked to date does not enter directly into the computation of progress. However, there should normally be a close relationship between actual hours worked and budgeted hours earned. If the budgets are accurate, the number of hours actually expended to complete any given task will closely approximate the hours budgeted for that task.

On a bi-weekly basis, foremen estimate the percentage of each task which has been completed. The larger tasks, i.e., those with budgets of more than 1,000 labor hours, have pre-established milestones which must be achieved in order to earn progress on the task. The hours budgeted for a task are multiplied by the percentage of completion claimed by the foremen to compute the number of budgeted hours which have been earned. The earned budgeted hours for all tasks are added together to determine the total hours earned to date in constructing the submarine. This result is divided by the total hours budgeted for construction in order to compute the percentage of labor progress on the submarine.

In March 1982, Electric Boat added approximately 16 million labor hours to its submarine construction budgets, with the majority of the hours being added to tasks which were in process or had already been completed. The increased budgets were then multiplied by the percentages of completion claimed by the foremen. As a result, Electric Boat claimed to have earned 12.6 million labor hours during a two week period in which it had worked 1.8 million hours. A 12.6 million earned hours would have been used in computing percentages of completion for submarine construction and, ultimately, in computing progress payments if the Navy had not acted to suspend Electric Boat's progressing system.

Senator PROXMIRE. Did the Navy agree that those hours were earned?

Admiral **Cantrell**. I have not seen the report, but if Electric Boat made a submittal saying that they achieved so many earned man-hours, I certainly accept that. Then it's the Navy's responsibility to determine the earned man-hours, the physical progress, and then the responsibility of the local auditor of how many man-hours were actually expended. It's a very complex formula and calculation and we have to be very careful to not mix different features of it. Physical progress is the main product and that is heavily influenced by the estimate to complete and at the time when they're optimistically projecting early completion you're going to get a much higher percent progress. And when you say we're not going to make it with these man-hours, suddenly the figure drops.

Senator **Proxmire**. Mr. Landicho, do you want to make a comment on that?

Mr. **Landicho**. Well, we also point out that Supships didn't like this idea and Supships, as we point out in the statement, resorted to another method and, as we point out, they suspended the payment. I will say that 12.6 million hours were earned hours. Then, we showed it against the actual 1.8 million hours. I'd just like to say again, all of this information is available to the Navy in the context of its own documents.

NAVY SUSPENSION OF REPORTING SYSTEM

Mr. **Kaufman**. Admiral Cantrell, can you explain why the Navy decided to suspend Electric Boat Shipyard's system of reporting progress in April 1982?

Admiral **Cantrell**. I have not discussed the specifics with individuals who made that decision because the people onsite, the local supervisor of shipbuilding, is the one who has the responsibility, but from my knowledge of how this system works, they found the discrepancy; therefore they suspended payments. That's the normal action to take.

So given that the physical progress was now no longer equating to that which was reported by the company, they suspended payment.

Mr. **Kaufman**. Wasn't that a rather drastic step to take instead of discussing the submission with the company, to actually suspend the use of the company's reporting system and to decide to make the calculations of physical progress and progress payments in the Navy itself until the company revised its system of reporting?

Admiral **Cantrell**. I'm not sure how strong the connotation of radical is. In the administration of our contracts, this is not an uncommon event. It's the leverage that a local supervisor has. It occurs at other plants. It may occur only for 1 week. It may occur for 2 or 3 months.

Mr. **Kaufman**. In this case, it occurred for about a year. Wasn't that an unusually long period?

Admiral **Cantrell**. Yes, and this was the period during which—I'm sure you recall—Electric Boat had a breakdown in their quality control system, the defective workmanship, the problems with Mr. Veliotis. There were severe management problems at EB. This is when the whole system broke down and the Navy was having to protect their interest by stopping the cash-flow until that was sorted out.

Mr. **Kaufman**. Isn't it correct that the company's reporting system was misrepresenting actual progress on the completion of the ships at that time?

Admiral **Cantrell**. The formula employed by the company in accordance with the Department of Defense Instruction 7000.1 was producing a number which was not truly reflective of the physical progress.

PROGRESS PAYMENTS

Senator **Proxmire**. Admiral Campbell, can you explain the justification for paying shipbuilders more than 100 percent of cost on progress payments? In one case, they paid 115 and in another case, 110, according to GAO.

Admiral **Campbell**. Well, again, Admiral Cantrell is probably the more knowledgeable witness in this regard, but I can say generally we do it in very rare cases. Progress payments are—you asked earlier when you were talking to the GAO people, I believe, what they were about. During the period of time we're talking about where we had the retentions and high progress payments, interest rates in the country were running somewhere around 17 percent, prime rate. So the cost of interest to the contractor, of course, is not a deductible cost and it's really unrealistic to think that a contractor is going to be able to afford $600, $300, whatever hundred million dollars we're talking about for this one contract.

Senator **Proxmire**. What we're talking about is a payment of 110 percent or more as late as August 1985 still taking place and it means that the taxpayer is handing over to the defense contractor funds they didn't expend and funds they can invest and get a return on.

Admiral **Campbell**. The way that ordinarily takes place is when you start up a shareline. Otherwise it should not exceed 100 percent. Let me offer Admiral Cantrell the opportunity to respond to that. He's certainly much more knowledgeable about that.

Senator **Proxmire**. I want to get to Admiral Cantrell, but the point that I want to see if I can understand is why there should ever be payments in excess of 100 percent.

Admiral **Campbell**. Again, it's a shareline situation. After you pass target cost there's a shareline and there's a chance that it can rise, but it usually does not rise dramatically and it's very rare that it goes over 100 percent.

Senator **Proxmire**. I don't see that there's any connection as far as the shareline is concerned because more than 100 percent means that the Federal Government is paying to a contractor more than the contractor is expending.

Admiral **Campbell**. Let me defer to Admiral Cantrell.

Senator **Proxmire**. All right. Fine.

Admiral **Cantrell**. I understood the GAO to say that they had indications of payment in excess of contractor cost. I cannot respond to that. I know of cases where the Navy pays in excess of 100 percent progress, but again because progress payments create sort of a synthetic dollar. But the retention clauses, the withholding of payments, are set up such that the Government always withholds some dollars fewer than the contractor expends.

Senator **Proxmire**. Well, I would think that would certainly be logical and I don't allege and I think the GAO made it clear that they weren't talking about 100 percent of the final cost, but they give them the money in advance. Ultimately, they give them the amount, but because they give it in advance they have an interest-free loan.

Admiral **Cantrell**. If the contractor expends fewer man-hours to achieve greater physical progress than is associated with that percentage expenditure, he will get on the shareline part of the incentive, some increased progress payment. In other words, if it takes 1,000 man-hours to do the job, when he's expended 900 man-hours, if he has done 100 percent of the job, he gets paid. The work is completed.

Senator **Proxmire**. It's hard to believe that of General Dynamics with their record—with their record on these submarines—that they were so efficient that they were paid more because they were able to economize on labor and come in with a lower cost.

Admiral **Cantrell**. Yes, sir, Mr. Chairman. Mine was an explanatory example not applicable to Electric Boat.

Senator **Proxmire**. Are you saying you're giving them a profit in advance? Of course, they make a profit if they cut down on their costs below the—and that's fine—but do they get it in advance?

Admiral **Cantrell**. When they have achieved completion, they get paid for completion.

Senator **Proxmire**. But this is during the actual work, so they're being paid in advance.

Admiral **Cantrell**. He is being paid his progress payments based on physical progress. If a 50 percent of the projected cost to do it, he's expended 40 percent of his man-hours but achieved 50 percent progress, he gets paid for actual progress incurred. That incentivizes efficiency and ultimately greatly reduces the cost of the product.

RETENTION CLAUSES

Senator **Proxmire**. Admiral Campbell, are you aware that special clauses were placed in General Dynamics' Trident and attack submarine contracts while Mr. Sawyer was Assistant Secretary removing the ceiling from progress payments?

Admiral **Campbell**. Removing the ceilings from progress payments?

Senator **Proxmire**. Yes, sir. That was the testimony of the GAO.

Admiral **Campbell**. I'm aware that a number of clauses were placed in those contracts during Mr. Sawyer's tenure. Most of them dealt with things other than the subject that you've talked about.

Senator **Proxmire**. And you heard I think—you were in the room, I believe, when the GAO testified that they were getting as high as 115 percent. How do you justify this action and the making of progress payments equal to 115 percent?

Admiral **Campbell**. I'll have to respond to that for the record because that's really not within my purview as Inspector General and I don't have that information here.

[The following information was subsequently supplied for the record:]

PROGRESS PAYMENTS

The standard Navy shipbuilding progress payments clause permits the contractors to receive payments in excess of costs incurred up to a ceiling of 105 percent of those costs. This is done to account for the extremely long construction period associated with shipbuilding contracts. Since most contracts contain profit percentages in the 10 to 15 percent range, the operation of this clause results in "earned profit" retained by the Government. The intent of the "Special Procedures Concerning Contract Retentions" clause was to incorporate a ceiling on the total amount of these withholdings. It was felt that use of the standard shipbuilding payments clause in conjunction with the high inflation and interest rates of the period (1980–1983) would result in dollars retained by the Government in excess of those required to meet the intent of the clause, i.e., to ensure that (1) the Contractor is incentivized to deliver the product on time, (2) the Government protects its rights under the warranty provisions of the contract, and (3) the Contractor is incentivized to close out the contract. In some cases, this modified retentions procedure resulted in payments in larger amounts than is normally permitted under the standards payments clause.

Senator **PROXMIRE**. Can anybody justify it here this morning? We asked the Navy to send up the people who were most competent in this regard and you're a fine witness and obviously a very intelligent man. You're very well informed here. But I'm surprised that you can't justify this remarkable policy which on its face seems to be a shocking and seems to be a waste of the taxpayers' money.

Admiral **CAMPBELL**. Well, two problems, Mr. Chairman. First of all, we thought initially the hearing was going to center on the Kalmin allegations and as the IG I was the most logical person to come because my office did that investigation. Second, again, I'll point out that we did not have and still do not have the GAO report, and while we like to respond to GAO reports and give them input going into their final report, which we will do on a timely basis by this Friday, we did not have it coming here today.

Senator **PROXMIRE**. In my January 6 letter, let me just read this, Admiral Cantrell, and then you can respond. In the letter we said the prices and profits of shipbuilding contractors have been the subject of correspondence between Secretary Lehman and myself for more than a year. In addition, the Joint Economic Committee counsel has been examining materials provided by the Navy concerning the contract prices and has discussed them with the Navy officials. Then we said:

> The following questions are intended to help you focus: (1) How do you explain the sharp increase in prices and profits of the 688 and Trident contracts awarded to General Dynamics and of the 688 contracts awarded to Newport News beginning in fiscal year 1981? What is the Navy's response to the GAO findings concerning Trident progress payments, long leadtime funds, and destruction of records?

We asked you that 4 or 5 days ago when we wrote you.

Admiral **CAMPBELL**. That's accurate, but you didn't tell us what you were asking us. We didn't know what GAO said.

Admiral **CANTRELL**. The question that's on the table, sir, the last one—what is the Navy's explanation for actual payments at 115 percent of costs incurred by the contractor, which GAO presented for the first time here—that's the first I had heard it and we would have to research that. I know of no fixed price incentive contract where costs incurred can result in the Navy paying 115 percent of costs without a claims situation.

Senator **Proxmire**. Mr. Landicho, didn't you brief the Navy twice about these findings?

Mr. **Landicho**. Yes. It occurred at two levels; namely, at Supships in Groton and also on January 2 where we had a group of Navy officials where we went through each one of these observations.

Senator **Proxmire**. You went through each one of the observations at that time?

Mr. **Landicho**. Yes, sir.

Senator **Proxmire**. And that second one was here in Washington, DC?

Mr. **Landicho**. That's right.

Senator **Proxmire**. Admiral Campbell, do you know if this clause that permits 115 percent of costs has been in Newport News or any other contracts?

Admiral **Campbell**. I don't know because I'm not familiar with that clause.

Senator **Proxmire**. Will you supply that for the record, sir?

Admiral **Campbell**. Yes, sir.

[The following information was subsequently supplied for the record:]

Retention Clause

CONTRACTS WITH SPECIAL RETENTION CLAUSE

N00024-80-C-2023—General Dynamics—Trident.
N00024-81-C-2075—Newport News—688's.
N00024-81-C-2134—General Dynamics—Trident.
N00024-82-C-2055—General Dynamics—688's.
N00024-83-C-2033—Newport News—CVN.
N00024-83-C-2039—General Dynamics—688's.
N00024-84-C-2063—General Dynamics—688's.
N00024-84-C-2064—Newport News—688's.

LONG LEADTIME FUNDING

Senator **Proxmire**. How do you explain the large unobligated balances in long leadtime funds for Trident?

Admiral **Campbell**. That question again is one that the Navy has been asked and we were initially told that we needed to respond by January 10. GAO asked us additional questions and these are very detailed and difficult questions. They are not questions that you can answer off the top of your head. GAO has assented to us providing answers to those questions by this Friday, the 17th.

Senator **Proxmire**. So the answer is at the present time you don't know?

Admiral **Campbell**. I can generally discuss the area that you're talking about. When we're talking about long leadtime, for instance——

Senator **Proxmire**. The question is, has this clause been used in Newport News or any other contract, the clause permitting——

Admiral **Campbell**. That's not a clause——

Senator **Proxmire**. I beg your pardon—about long leadtime funds for the Trident? I'm talking about the large unobligated balances in long leadtime funds for the Trident.

Admiral CAMPBELL. I can address that question in very general terms only. You start out with the fact that you budget for these things——

Senator PROXMIRE. We want the answer to the question. We want them as specific as you can get them. Will you do that?

Admiral CAMPBELL. Well, we've been provided that question to answer to GAO and we will provide you with a comprehensive answer by this Friday. I cannot provide you a comprehensive answer today.

Senator PROXMIRE. That's fine.

[The following information was subsequently supplied for the record:]

LONG LEADTIME FUNDS FOR TRIDENT

The information was provided to the General Accounting Office on Thursday 16 January 1986.

Senator PROXMIRE. Now what happens to the funds when they are not spent? Does the Navy return the money to the Treasury?

Admiral CAMPBELL. You're talking about obligated funds?

Admiral CANTRELL. Funds authorized by Congress for long leadtime material become part of the shipbuilding contract and part of the material cost and are used to make payments on the contract, not long leadtime funds.

Senator PROXMIRE. But if they're not spent here, are they returned to the Treasury?

Admiral CANTRELL. Yes, sir, on the shareline because material shows up on the shareline.

Senator PROXMIRE. You say they're not spent on long leadtime, they're spent on the contracts.

Admiral CANTRELL. Long leadtime is spent for material, whether the intention of getting it is for material based on market conditions, changes in things that are converted to CFE, things that are needed to support the orderly construction of a ship to hold down the cost of the ship. The material becomes just plain material once it's plowed into the contract. Once the contract is awarded it's material cost. It doesn't do anything to increase the cost of the contract, decrease the cost of the contract or change the profit. If it's expended, it's paid under the shareline. If it's not expended, it's returned to the Government under the shareline.

Senator PROXMIRE. Admiral Campbell, GAO identified materials that did not need to be purchased prior to the Trident contract and thus did not have to be part of the long leadtime funding.

Whose fault was it that this occurred?

Admiral CAMPBELL. Again, not having looked closely—not having had the question posed and all the information, I don't know which material you're talking about—for a fact that it was not necessary. I'm sure that there was some. You have to realize that in these contracts that there are perturbations in the budget cycle so that we plan one Trident a year and on at least one occasion that's fallen out. So some of those are the reason the contractor has to crank an allowance into what he's doing for procurement time and manufacturer's time. We try to have it available because if we have to stop construction that's very expensive. So we're going to miss on occasion and undoubtedly have, and these may have been the misses that you're talking about. I don't know. I don't know what misses they are.

Senator **Proxmire**. Well, in this case, the Navy missed by about $180 million—that'a a pretty big miss—according to GAO's report.

Admiral **Campbell**. We now have the GAO report. I will take it and respond to it and get back to you.

Senator **Proxmire**. You were briefed on it January 2.

Admiral **Campbell**. We were not briefed on—I have never seen those figures before.

DESTRUCTION OF RECORDS

Senator **Proxmire**. Admiral, your office investigated the destruction of records allegation.

Admiral **Campbell**. That's right.

Senator **Proxmire**. Were all the officials in the office where the destruction took place questioned?

Admiral **Campbell**. I'm very confident that every person in the office was not questioned. On the other hand, I know that people in the office were questioned. I would also point out that this destruction started long before there were any investigations going on. I would also like to point out that the allegator, the person who made the allegations, helped participate in deciding which of those documents were destroyed. There's been much said about why—we did put the titles in our destruction records of what these documents were. There's been much said about not putting in the classification codes. One of the problems with that system of records and the reason that we decided to go to a new system of records was to get rid of stuff that we did not need and bring us into conformance with Navy standards. Those records did not have those codes on them.

Mr. **Kaufman**. Admiral, you said that you're confident not all of the individuals in the office where the destruction took place were interviewed during the course of the Inspector General's investigation.

It was said earlier that if some of them were aware that there were other ongoing investigations by the FBI and the NIS at the time that the destruction took place that the destruction would have been improper.

Now if some of the individuals weren't questioned by the Inspector General, how do you know that those individuals who weren't questioned may not have been aware or may have been aware of the other investigations?

Admiral **Campbell**. Well, to begin with, as I mentioned just a minute ago, the destruction of records started before any investigation was underway and, again, as I pointed out, Mr. Kalmin participated in identifying those documents that were going to be destroyed.

I did not personally know and I don't think my office knew that some of the investigations you're talking about were going on. I was not in the office at the time. I've viewed the records we had as to who was talked to. There obviously are some references to people in 396P who were talked to. I'm confident that everybody in there was not. I am also confident that a significant number of people in there were talked to and I'm not sure it's necessary in the course of an investigation to talk to everybody in an office to find out whether they knew an investigation was going on, particularly when there was no investigation going on when they started the destruction.

Mr. KAUFMAN. The period in question began in September 1983.

Admiral CAMPBELL. That's correct.

Mr. KAUFMAN. And went through September 1984.

Admiral CAMPBELL. Yes, sir.

Mr. KAUFMAN. Now September 1983 happens to be the same month that Mr. Veliotis was indicted for allegedly taking kickbacks on Navy contracts possibly including the Trident. It was following that period in the next few months that the Justice Department began looking into the matter and I understand the Navy Investigative Service also began looking into the matter and there were investigations begun on Capitol Hill by several congressional committees into possible irregularities in the Trident and other shipbuilding programs.

You are aware, are you not, that all of this investigative activity was going on during that period while the records were being destroyed?

Admiral CAMPBELL. I am aware that none of those investigations had any focus on NAVSEA 396P. What happened insofar as our investigation was these things started with allegations made by Mr. Kalmin in late December 1983. They came to the attention of my office in early spring of 1984 and that's when our investigation took place and that's when NIS started investigating as well.

Senator PROXMIRE. Admiral Campbell, how do you explain the fact that these individuals were not aware of so many investigations, including some in the Navy, when it's such an important program? Was this a failure of communication?

Admiral CAMPBELL. Well, again, the investigations involving Mr. Veliotis, investigations of that scale, everybody was aware of them. They had, insofar as the people in 396P were concerned, no relevance because nobody was concerned with what they had done.

Investigations involving my shop in the spring of 1984, I don't know if they were aware of them or not aware of them at that point.

Senator PROXMIRE. Well, here we have a situation in which documents were destroyed that could be very important to the FBI, important to the Navy, and they were destroyed, and they were destroyed apparently at a time when investigations were going on and when the destruction of those records therefore was illegal.

Admiral CAMPBELL. Well, the destruction of those records was not illegal.

Senator PROXMIRE. Well, it certainly was improper.

Admiral CAMPBELL. The destruction of records was started long before——

Senator PROXMIRE. It may have been illegal.

Admiral CAMPBELL [continuing]. Any of these investigations were going on as a routine managerial task to bring our files into conformance with Navy standards. That's all it was viewed as. Even Mr. Kalmin, who made the original allegation, has said in the statements he made to my investigators, that he knew of no causal relationship between the destruction and his allegation. He's made that statement.

Senator **Proxmire**. Well, you say, as I understood you to testify earlier, that the records were irrelevant or were deemed to be irrelevant, but that certainly isn't—they were thought to be irrelevant by the people who destroyed them, but that isn't for them to decide, is it? That's something the FBI or the Navy investigators should decide.

Admiral **Campbell**. Well, it's for them to decide and it's for the latter group of people to decide, too. Those things were looked at, again including by the allegator, Mr. Kalmin.

Senator **Proxmire**. Gentlemen, I want to thank you very much. I have a closing statement I would like to make at this point.

The testimony we have received today is disturbing for several reasons. The price increases described seem totally unjustified and harmful to the defense effort and costly to the taxpayer. It is no more justified for a defense contractor to charge more for the same or slightly modified product than for a commercial manufacturer. The customer is gouged in both cases. Whether real price hikes occurred in other areas of defense production remains to be seen. The evidence of overpricing of spare parts is not comforting.

The GAO report demonstrates that problems with General Dynamics Shipbuilding continued into the 1980's. These problems appear to include misrepresentations to the Navy and discrepancies concerning long leadtime funds, according to the General Accounting Office.

The Navy, for reasons that have not been explained, slipped a clause into several ship contracts removing the lid from progress payments. Secretary Lehman has gone on record saying that former Assistant Secretary George Sawyer saved the taxpayer billions of dollars with innovations in contracts. The Navy has so far failed to answer the demonstrated fact that the evidence so far indicates the opposite.

Our investigation will continue while the subcommittee stands in adjournment.

[Whereupon, at 12:50 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following letters were subsequently supplied for the record by Senator Proxmire:]

DEPARTMENT OF DEFENSE
UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
OFFICE OF LEGISLATIVE AFFAIRS
WASHINGTON, D.C. 20350

IN REPLY REFER TO
14 January 1986

Richard F. Kaufman
General Counsel
Joint Economic Committee
Washington, D.C. 20510

Dear ~~Mr. Kaufman~~ Richard

Pursuant to our conversation of last evening, enclosed herewith are specific Navy estimated cost and manhour data requested in Vice-Chairman Proxmire's letter of January, 6, 1986, and subsequent telephonic requests by you, in connection with the hearing to be held today by the Subcommittee on Economic Resources, Competitiveness, and Security Economics.

Please note that the SSN 688 cost and manhour documentation provided you is marked business sensitive and is provided with the caveat that it not be made public in light of ongoing SSN 688 contract competition.

Enclosed herewith also is a copy of Rear Admiral Campbell's statement. Other required copies will be provided as soon as possible.

Sincerely,

Bill

William D. Cohen
Captain, JAGC, U.S. Navy
Director, Legislation

SENATOR PROXMIRE
8 JANUARY 1986

Q.2 What are the current estimated costs to complete each of those contracts?

A.2 The estimated costs to complete the OHIO Class Submarine shipbuilding contracts awarded to Electric Boat Division/General Dynamics are as follows:

($000)

- Contract N00024-75-C-2014 (Group II) for the construction of SSBN 730, SSBN 731 and SSBN 732.

CURRENT ESTIMATED COST	CURRENT ESTIMATED PROFIT	CURRENT ESTIMATED PRICE	CURRENT ESCALATED COST	% PROFIT
824.9	185.2	1010.1	1,279.5	14.5

- Contract N00024-80-C-2201 (Group III) for the construction of SSBN 733.

CURRENT ESTIMATED COST	CURRENT ESTIMATED PROFIT	CURRENT ESTIMATED PRICE	CURRENT ESCALATED COST	% PROFIT
363.3	48.9	412.2	510.1	9.6

- Contract N00024-81-C-2134 (Group IV) for the construction of SSBN 734, SSBN735 and SSBN 736.

CURRENT ESTIMATED COST	CURRENT ESTIMATED PROFIT	CURRENT ESTIMATED PRICE	CURRENT ESCALATED COST	% PROFIT
1,406.1	269.6	1,675.7	1,851.6	14.6

- Contract N00024-85-C-2062 (Group V) for the construction of SSBN 737.

CURRENT ESTIMATED COST	CURRENT ESTIMATED PROFIT	CURRENT ESTIMATED PRICE	CURRENT ESCALATED COST	% PROFIT
537.7	78.7	616.4	693.3	11.4

SENATOR PROXMIRE
8 JANUARY 1986

Q3. What are the current manhours to complete each of those contracts?

A3. The projected hours to complete each OHIO Class shipbuilding contract and the current expended hours are as follows:

DATA AS REPORTED 12/21/85
(End of Year Report)

CONTRACT #	PROJECTION	EXPENDED
N00024-75-C-2014	39616851	39386224
N00024-80-C-2201	12862870	11312917
N00024-81-C-2134	39996916	16348979
N00024-85-C-2062	11904192	331735

BUSINESS SENSITIVE

The estimates for SSN 688 contracts awarded to General Dynamics and Newport News since 1981 are as follows: (Contractor Cost Report Data)

Contract N00024-81-C-2075 with Newport News for the construction of SSNs 721-723 and SSN 750.

Current Estimated Cost	Current Estimated Profit	Current Estimated Price	Current Escalated Cost	% Profit
$831.7	$142.1	$973.8	$1,021.0	13.9%

Contract N00024-82-C-2055 with General Dynamics for the construction of SSN 724-725.

Current Estimated Cost	Current Estimated Profit	Current Estimated Price	Current Escalated Cost	% Profit
$453.6	$65.8	$519.4	$569.6	11.5%

Contract N00024-83-C-2039 with General Dynamics for the construction of SSN 751-752.

Current Estimated Cost	Current Estimated Profit	Current Estimated Price	Current Escalated Cost	% Profit
$508.0	$67.6	$575.6	$572.9	11.7%

Contract N00024-84-C-2063 with General Dynamics for the construction of SSN 754-755 and SSN 757.

Current Estimated Cost	Current Estimated Profit	Current Estimated Price	Current Escalated Cost	% Profit
$773.5	$71.4	$844.9	$867.6	8.2%

Contract N00024-84-C-2064 with Newport News for the construction of SSN 753, SSN 756, and SSN 758-759.

Current Estimated Cost	Current Estimated Profit	Current Estimated Price	Current Escalated Cost	% Profit
$966.2	$120.0	$1,086.2	$1,112.1	10.7%

BUSINESS SENSITIVE
Current manhours to complete each of these contracts are:

	M/H in Millions	
Contract	Est. M/H at Completion	M/H Incurred To Date
N00024-81-C-2075	27.8	21.2
N00024-82-C-2055	15.2	10.8
N00024-83-C-2039	14.2	6.3
N00024-84-C-2063	19.1	4.3
N00024-84-C-2064	23.9	2.0

The VLS contract modification for both the SSN 719 and SSN 720 was as follows: (In base year Feb 1978)

Cost	23.6
Profit	4.7
Price	28.3

Contract manhour estimates should be treated as "Business Sensitive" as this information could impact future submarine contract awards.

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DEPUTY DIRECTOR

June 25, 1986

Mr. Everett Pyatt
Assistant Secretary of the
Navy (Shipbuilding and
Logistics)
Department of the Navy
Washington, D.C. 20360

Dear Mr. Pyatt

Thank you for your letter of June 9, 1986.

In my January 6, 1986, letter to Admiral Don Campbell, I asked for information in a number of areas which I planned to discuss at the forthcoming hearings on ship contracts.

Among the questions was the following: "What were the prices proposed by Newport News for the 721, 722, and 723 submarine contracts when competitive bids were invited prior to the decision to award the contracts on a sole-source basis?" Elsewhere in the letter, I stated "all figures for prices and profits should be stated as they appear in the relevant contracts and proposals, and also on the basis of target cost escalated, target profit, and target profit as a percent of escalated cost."

During the hearing on January 14, 1986, I asked ADM Campbell again for the figures, which had not yet been supplied. He responded that the March 1980 Newport News proposal was for two ships at approximately $147 million per ship. ADM Campbell then agreed to supply additional information about that bid for the record.

ADM Campbell later supplied written material on this question for the record. However, the submission for the record did not provide any further breakdown of the competitive bid. As a result, the Committee staff made an oral request to the Navy for a breakdown of the competitive bid in accordance with the request in my January 6 letter.

Your letter of June 9 contains a breakdown of Newport News" proposal submitted in April 1981. It is the type of breakdown I requested, but it is for the wrong date. I have been trying to get the breakdown for the proposal submitted in 1980 under the competitive solicitation. I do not understand why the Navy has been so far unable to give me the information as I have been quite specific in my requests.

Please provide me with the information I have requested, namely, the breakdown of the proposal submitted by Newport News under the competitive solicitation for SSN's 721, 722, and 723, which, I am informed, was submitted in March 1980. As a great amount of time has elapsed since I made my original request, I hope that you will expedite the reply.

On a related matter, during your March 14, 1986, appearance before the Senate Subcommittee on Defense Appropriations, I asked that you provide me with the contracts and business clearance memoranda for the AEGIS cruisers, CVN's, and other weapons contracts awarded during 1981-1983. The purpose of the request is to examine contract prices during this period. So far, I have not received the information you agreed to supply.

The staff of the Joint Economic Committee has been assisting in the analysis of contract price data. I would like your office to work with Richard F Kaufman of the JEC staff on this matter, and to supply him with the information I have requested.

Again, it seems to take the Navy long periods of time to provide information requested at Committee hearings. I hope you will also expedite this matter.

Your cooperation will be greatly appreciated.

Sincerely,

William Proxmire

William Proxmire
Vice President
Subcommittee on Economic
Resources, Competitiveness,
and Security Economics

WP:rkt

DEPARTMENT OF DEFENSE
UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON D C 20360

AUG 01 1986

The Honorable William Proxmire
Vice Chairman
Subcommittee on Economic Resources,
  Competitiveness, and Security Economics
Joint Economic Committee
United States Senate
Washington, D. C. 20510

Dear Mr. Vice Chairman:

This is in reply to your recent letter in which you requested information and data on Newport News Shipbuilding and Drydock Company proposals relating to SSNs 721, 722 and 723 as well as other contract records.

The General Dynamics Electric Boat Division and Newport News were requested to submit separate proposals for one ship (SSN 721) and for two ships (SSNs 722 and 723). The solicitation did not request proposals for the construction of all three submarines by one shipbuilder. The prices contained in the Newport News March 1980 proposal are as follows:

	One Ship	Two Ships		Two Ships
	SSN 721	SSN 722	SSN 723	TOTAL
Target cost	$153,558,100	$148,748,450	$148,748,450	$297,496,900
Target profit	22,238,900	21,526,550	21,526,550	43,053,100
Target price	175,797,000	170,274,700	170,274,700	340,549,400
Ceiling(135%)	207,303,400	200,810,000	200,810,000	401,620,000
Share Ratio	80/20	80/20	80/20	

The proposed costs and prices were in de-escalated dollars (September 1979 dollars).

The $147 million figure addressed by Rear Admiral Campbell during the January 1986 hearings is an average cost per ship for three ships derived from the 1980 Newport News competitive proposal. The derivation of an average cost was necessary because the Navy had not requested competitive proposals on a three ship basis. The calculations for the average cost are shown below:

Newport News 1980 proposed Target cost for two ships	$297,496,300
Newport News 1980 proposed Target Cost for one ship	153,558,100
Difference (stand alone cost of second ship)	$143,938,200

It can be assumed that a third ship cost would not exceed the second ship stand alone cost of $143,938,200.

Target cost for two ships	$297,496,300
plus: stand alone cost for third ship	143,938,200
Total: Three ship cost	$441,434,500
Average cost per ship	$147,144,833

The above provides the full explanation of the derivation of the $147 million cost per ship that RADM Campbell cited. Attachment I, which was previously provided for the record, explains the difference between the $147 million figure and the negotiated target costs of contract N00024-81-C-2075.

The contracts and business clearances for the Aegis cruisers and CVNs for the period of 1981 - 1983 are provided as Attachment II. You also requested contracts and clearances for other weapons contracts during the same period. The research and duplication efforts on such a broad request will involve substantial time and cost. It would be appreciated if your staff could specifically identify which other contracts are desired.

The business clearances we have provided contain commercially sensitive information that has been provided in the proposals on the condition it not be released outside the Government. Therefore, the information should not be released to the public.

If we can be of further assistance, please let me know.

Sincerely,

Everett Pyatt

EVERETT PYATT
ASSISTANT SECRETARY OF THE NAVY
(SHIPBUILDING AND LOGISTICS)

DOCUMENTS FOR SENATOR PROXMIRE

CG PROGRAM

FY 81	Contract N00024-81-C-2049		Mods thru P00025	ISD
	Business Clearance 12,351.1 12,351.2 12,351.3			
FY 82	Contract N00024-82-C-2011		Mods thru P00022	BIW
	Business Clearance 12,456 12,456.1			
FY 83	Contract N00024-83-C-2013		Mods thru P00004	ISD
	Business Clearance 12,453.1 12,453.2			

CVN PROGRAM

	Contract N00024-80-C-2023	CVN 71	Mods thru P00013	NNS
	Business Clearance 12,330.1 12,330.2			
	Contract N00024-83-C-2033		Mods thru P00010	
	Business Clearance 12,480.1 12,480.2			

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June 25, 1986

Mr. Everett Pyatt
Assistant Secretary of the Navy
(Shipbuilding and Logistics)
Department of the Navy
Washington, D.C. 20360

Dear Mr. Pyatt:

A report prepared by the General Accounting Office on Navy ship contracting discusses, among other things, progress payments paid on certain Trident and 688-class submarines.

GAO's preliminary findings were presented at a hearing held on January 14, 1986. During the hearing, I asked the Navy witnesses, ADM Don Campbell and ADM W. H. Cantrell, to explain the Navy policy of reimbursing shipbuilding contractors on the basis of more than 100 percent of incurred costs. I also asked for an explanation of several special retention clauses in Trident and 688 contracts which allowed General Dynamics to receive progress payments that substantially exceeded amounts that would have been paid under normal progress payment claims. At one point, according to GAO, General Dynamics was receiving progress payments equivalent to about 115 percent of incurred costs.

The Navy witnesses were unable to provide adequate explanations for either the general policy regarding progress payments or for the special retention clauses. I would like you to provide me with the explanations. In addition, I would like you to provide comments on the GAO findings in the report with respect to over-progressing of submarine construction and advanced procurement of long lead time material. A copy of the GAO report, "Navy Contracting: Allegations About Trident Submarine Program Matters," is enclosed.

I will be grateful for your cooperation.

Sincerely,

William Proxmire
Vice Chairman
Subcommittee on Economic Resources,
Competitiveness, and Security
Economics

DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON D C 20360

AUG 04 1986

The Honorable William Proxmire
Vice Chairman
Subcommittee on Economic Resources,
Competitiveness and Security Economics
Joint Economic Committee
United States Senate
Washington, DC 20510

Dear Mr. Vice Chairman:

This is in response to your recent letter in which you asked for an explanation of progress payments and special retention clauses in Trident and SSN 688 contracts. In addition, you requested comments on the GAO report entitled "Allegations About Trident Submarine Program Matters."

Each of the issues are addressed in Attachment I. If we can be of further assistance, please let me know.

Sincerely,

Everett Pyatt

EVERETT PYATT
ASSISTANT SECRETARY OF THE NAVY
(SHIPBUILDING AND LOGISTICS)

Enclosure

ATTACHMENT I

PROGRESS PAYMENTS

Consistent with the contract financing principles contained in the Defense Acquisition Regulation and the Federal Acquisition Regulation, it is the policy of the Navy to provide funding for a contractor's working capital on shipbuilding contracts. This practice is employed because:

The shipbuilder will not be able to bill for the first delivery of the ship for a substantial time after work must begin.

Shipbuilding contracts are usually large dollar value.

The shipbuilder will make expenditures in constructing the ship prior to delivery that have a significant impact on its working capital.

The regulations and implementing policies authorize progress payments on a percentage of completion basis rather than a cost incurred basis, since the period of performance for shipbuilding contracts is longer than for most other Government contracts (as much as 8 years for an aircraft carrier; six years for a TRIDENT submarine). The current shipbuilding progress payment clause permits the contractor to receive payments as follows:

If less than 50 percent of the contract is complete, the contractor will receive payments of 90 percent of the amount of physical progress completed multiplied by the contract price. In no event may the contractor receive more than 100 percent of costs incurred.

If more than 50 percent of the contract is complete, the contractor will receive payment of 95 percent of the amount of physical progress completed multiplied by the contract price. In no event shall the contractor receive more than 105 percent of costs incurred. The limiters of 100 and 105 percent are included to preclude overpayment if the physical progress measurements do not correlate with incurred costs.

Since most shipbuilding contracts contain target profit percentages in the 10-15 percent range of escalated costs, a substantial amount of withholdings or contract retentions is generated by the operation of this clause during the period of performance of shipbuilding contracts. During the time that physical performance is less than 50 percent complete, the contractor is able to bill for only 90 percent of the dollars he has invested in the contract (as defined by the measurement of physical progress) and no profit. For the remainder of the contract, the contractor receives payment for 95 percent of his investment plus a maximum of 5 percent profit. Therefore, the critical principle that the contractor should not be reimbursed through progress payments an amount which would detract from the contractor's requirement to complete performance, is maintained in shipbuilding contrcts. For example, on the Trident Group V contract (N000-85-C-2062), as of June 1986 at approximately 20 percent completed, the amount of retentions totaled over $27 million. On the Group II contract (N00024-75-C-2014), at approximately 85 percent complete, over $137 million was withheld.

SPECIAL RETENTION

In the early 1980's, certain Navy shipbuilding contracts which required the longest periods of performance (CVN, TRIDENT, and SSN 688) included a contract provision entitled "Special Procedures Concerning Contract Retentions." The intent of this clause was to incorporate a ceiling on the total amount of withholdings. It was felt that use of the standard shipbuilding payments clause during periods of high inflation and interest rates such as in the early 1980's would result in dollars retained by the Government in excess of those required to meet the intent of contract retentions, i.e., to ensure that (1) the contractor is incentivized to deliver the product on time, (2) the Government protects its rights under the warranty provisions of the contract, and (3) the contractor is incentivized to close out the contract. In some cases, this modified retentions procedure resulted in payments in larger amounts than is normally permitted under the standard shipbuilding payments clause. When interest rates began falling, the Navy discontinued use of the special retention clause.

OVERPROGRESSING OF SUBMARINE CONSTRUCTION CONTRACTS

The GAO found that the Navy took action to disapprove EB's computation of physical progress only after it became clear to SUPSHIP that significant overcompensation would occur using the contractor's method of computing physical progress. Prior to this action in March 1982, SUPSHIP had been negotiating with EB in an attempt to resolve discrepancies and irregularities in EB's progressing system. Rather than immediately withhold payment when the first problems were identified in October 1980, SUPSHIP attempted to resolve the issue through discussions with the contractor. The Navy feels that it was appropriate to wait until it became clear to the Supervisor of Shipbuilding to withhold payment that progress payments would be inflated using EB's calculation of measuring physical progress. To do otherwise would not have been a prudent business practice on the Government's part. No significant overprogressing occurred since SUPSHIP used their own method of calculating progress payments once it was evident that significant dollar amounts were involved. This did not occur until the contractor submitted his reallocated budgets in March 1982. The following month, SUPSHIP no longer relied on EB's method for calculating payments. The Navy feels there was no harm done the Government by EB or SUPSHIP's actions in this matter.

LONG LEADTIME MATERIAL

The GAO report found that some materials purchased under advance procurement contracts did not qualify as long leadtime material (LLTM). To support this finding, the report lists three items which did not qualify as LLTM. The Navy's comments on these items follow.

DIESEL GENERATOR

GAO states that since this generator had remained idle for two years after it was delivered, the RFP and purchase order could have been delayed two years and therefore the item did not have a sufficiently long leadtime to qualify for advanced procurement. However, GAO admits that the facts available at the time the LLTM list was prepared justified the inclusion of this item on the LLTM list.

FIRING VALVE

The purchase order for this item was issued in February 1983, nine months before the construction contract was awarded in November. Therefore, it is not clear from the GAO report why the firing valve was considered to be an inappropriate LLTM item. The fact that the budgeted dollars for this item fluctuated widely between years does not support the finding that this item did not belong on the LLTM list.

CONDENSATE PUMP

Given the fact that EB initiated the procurement of this item 7 months before the construction contract was awarded, the uncertainty surrounding the exact date when the option for the SSBN 736 would be exercised (it had been deleted from the FY-83 Authorization Act), and the subcontract and prime contract were awarded within a relatively short time span (3 months), it does not seem improper that this item was included on the LLTM list.

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